SCHEID VINEYARDS INC.

OTCMKTS: SVIN

ABSTRACT

Scheid Vineyards is a classic "heads I win, tails I don't lose that much" situation because the land they own protects the downside and the strategy that they will continue to execute provides an opportunity for significant upside.

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Scheid Vineyards Inc. (SVIN)

Ticker: SVIN

Price: $76.50

FD shares outstanding: 883,086

Market Cap: $67.6 million

Cash: $1.7 million

Interest Bearing Debt: $106.3 million

Enterprise Value: $172 million

Scheid Vineyards Inc. (SVIN) is a microcap company that recently "saw the light" by starting to report financials to the public again in March of 2018. The market price is currently not reflecting the full value of the properties that they own and is also not reflecting the value of the future prospects of the business correctly. This is a Mohnish Pabrai classic "heads I win, tails; I don't lose much" situation, in that the property they own provides downside protection, and the future shift in revenue mix will generate significant upside due to increased margins. 2018 was an exceptionally bad year for the company, as their 2017 grape harvest yield was below average, which has added downward pressure to the share price.

Scheid Vineyards Inc. is a vertically integrated winery that grows its own grapes, mashes them, and turns them into premium wine under several different brands. They began as a grape growing operation in Monterey County, CA, in 1972. Their business was originally focused on establishing long term contracts with wineries to provide them grapes. In the '90s and '00s, their strategy changed they turn to producing and selling bulk wine. Today, they're pivoting once again from selling bulk wine to selling their own brands.

Today, most of their revenue is derived from bulk wine sales and cased wine sales. Bulk wine refers to the sale of wine via large containers, usually for other wine brands to bottle, market, and sell. The bulk wine segment is extremely competitive. The sale of bulk wine leads to low gross margins due to the decreased price at which they sell the wine, with case sales being able to obtain a much higher price per gallon. Cased wine refers to selling their own brands of wine, which demand a higher price per gallon.

Scheid's current strategy is to transition from a seller of bulk wine to a seller of their own brands. This will lead to significantly more revenue with little increased costs simply from selling the volume of wine produced from bulk sales as case sales. There will be additional costs due to bottling, distribution, and marketing, but their margins should increase significantly due to the higher price at which they will be able to sell their own brands. To put things in perspective, Scheid has a 2 million case capacity, but only sold 517,000 cases last year. The majority of the volume of wine being produced right now is being sold as bulk wine.

Scheid Family Wines has several brands of wine (Scheid Vineyards, District 7, Metz Road, Stokes' Ghost, GIFFT, and VDR). Their vision is simple: "By 2025, Scheid Family Wines will become one of the most recognized wine producers in quality, innovation, and sustainability in the world." The key word in this vision is *recognized*. Bulk wine is sold to other brands. There is virtually no *recognition* of their brand when they simply outsource their product to other wineries. On top of this, Al Scheid essentially laid out their game plan in the December, 2017 issue of "The Tasting Panel", saying the following: "The correct way of getting into this industry is growing grapes for a minimum of 20 years before you make any wine, then once you start making wine, you should sell it to other wineries, because they're heavier task masters than the consumers… After you sell the bulk wine to wineries, you make your own wine, put a label on it, and try to sell it…". They are currently transitioning between selling bulk wine to other wineries to selling their own wine.

There have been some more recent developments to back this claim. They recently just signed a distribution contract with Martin Scott, a fine wine distributor covering New York and New Jersey. Additionally, they're currently hiring a sales manager in Texas and a sales manager for Virginia, Maryland, and D.C. They've stated in recent press releases that they're increasing their emphasis on selling bottled, rather than bulk wine. The evidence that their future sales will mostly be composed of cased wine sales is overwhelming.

On top of all this, their cased wine sales have exploded. They only sold 151,000 in 2015. They sold 517,000 in 2018. Better yet, there is plenty of room to grow based on their total capacity (about 3.8x 2018 case sales). This is what the market is missing. By 2025, I believe that the majority of their revenues will come from case sales and direct to consumer sales. This will lead to greater revenues and a much higher gross margin, making their large fixed costs more manageable and adding to the bottom line. The big question is if they can execute this transition. If they sold their bulk wine to other wineries, who then sold their own brand, I see no reason as to why Scheid would be unable to sell the same wine under their own Scheid brands. They successfully transitioned from selling grapes to selling bulk wine, arguably a much harder transition to make than the one they are currently undergoing. Management has made a big transition once, and I believe they will successfully make another big transition again.

Al Scheid (chairman and founder) has been with the company since the beginning. He has former investment banking experience. Al owns 19.76% of the company. Scott Scheid (president and CEO) has been with the company for 32 years, but spent 4 years as an options trader in NYC before he came on board. Scott owns 10.22% of the company. Heidi Scheid (executive vice president) joined the company in 1992 and has some experience in valuation consulting. Heidi owns 11.52% of the company. All three of them collectively own 41.5% of the company. Because of the extremely high insider ownership, there is very little float. The low float and small market combined with the fact that they only recently started publishing financial reports again has led to illiquidity and mispricing.

The shares are split between A shares (735,617 S/O) and B shares (147,469 S/O). B shares receive 5 votes for every 1 A share. The Scheid family has control voting control at around 58.88%.

The wine industry is highly fragmented and extremely competitive. In 2017, it is estimated that 277.9 million cases from California were shipped to the US and the world, with the US making up 240.7 million cases of this. This resulted in around $35.2 billion worth of sales in the US. To put things in perspective, Scheid Vineyards Inc. produced $50.23 million in wine sale revenue in 2017. There are 4,391 wineries in the state of California. On the bright side, California wines have experienced significant growth over the past decades, with premium wines mainly making up most of that growth. Scheid's scale and product quality gives them an edge over the smaller wineries, as they are able to produce more wine at a cheaper cost.

Scheid has seen sales growth of 10% per year since 2015. This growth can be attributed to their emphasis on selling more cased wine. The dynamic between case wine sales and bulk wine sales has changed significantly from 2015 and I believe is likely to continue to change in the future.

	2018	**2017**	**2016**	**2015**
Revenues:				
Cased Goods Sales	47.20%	37.34%	34.98%	19.94%
Bulk Wine Sales	31.79%	40.69%	44.61%	51.35%
Grape Sales	8.32%	12.01%	10.40%	14.82%
Winery Processing & Storage Revenues	7.97%	6.26%	6.15%	9.49%
Direct Sales Revenues	3.46%	2.66%	2.58%	2.84%
Vineyard Mgmt, svcs, and other fees	1.25%	1.04%	1.26%	1.55%

Cased goods sales have grown 46.63% per year since 2015, while bulk wine sales have decline by 6.23% each year. Another favorable trend is the increase in direct sales revenues, which are revenues derived from selling wine directly to customers (e.g., at the winery or online). This has grown 17.55% per year. Cased goods sales and direct sales growth are favorable trends because they are higher margin revenue streams. Crimson Wine Group LTD. (CWGL), another producer of premium wines in California, achieves a 70% gross margin on direct to consumer wine sales and a 44% gross margin on cased goods sales. Crimson Wine only has the capacity to make around 633,000 cases of wine. Scheid's margins should be higher due to the larger scale of their operation.

Now, for my favorite part of the analysis. I bought four bottles of wine from their website and gave some to friends and family to try (some Chardonnay and Pinot Blanc – next up will be some of the reds). All were very pleased with the taste of the wine. On top of this, Scheid's premium brands (Stokes Ghost is included under Scheid Vineyards) carry an above average rating on Vinino, a popular wine rating app (the lower priced wine brands carry an average rating, however). They also have a partnership with Kathie Lee Gifford's wine label, GIFFT. This brand carries a 3.6 rating and is priced at the lower end of their brands.

- Premium Wine Brands:
    - Scheid Vineyards: 3.9
    - Metz Road: 3.8
    - VDR: 4.1
- Lower Priced Wine Brands:
    - District 7: 3.5
    - Ranch 32: 3.5

Overall, people tend to really like their premium wine products. This will make for an easier transition, as they have products that are desirable and therefore more marketable.

The one concern I have with the company is the amount of leverage within its capital structure. They recently took out $100 million in debt backed by the value of their properties. They carry 2.74x more debt than equity. They have an extremely low interest coverage ratio and are highly levered compared to other wineries. However, the amount of debt in their capital structure speaks more to the value of their properties than anything else. Modigliani and Miller would probably agree that taking out debt on valuable properties is an effective way to finance a company, as the weighted average cost of capital is cheap. By taking out this new debt, they effectively refinanced their old debt that was held by Rabobank N.A. There was a significant amount coming due within the next few years. Under the new debt, $3.84 million is due in 2023 and $70 million is due in 2033. This gives Scheid plenty of time to transition from a bulk wine seller to a cased wine seller. It is also worth noting that there was a covenant within the Rabobank N.A. debt that prohibited Scheid from paying out any dividends. They may or may not have the ability to pay out a dividend under the terms of the new debt.

Another interesting note, the PGIM debt covers all but four of the parcels that they own. Three of these parcels were recently rezoned to highway commercial, heavy industrial, and low-density residential type properties. In the '80s, they rezoned some property they had bought in the '70s and then sold it for a "handsome" profit. I believe that they are going to do the same thing with these parcels of land.

Scheid is currently trading below liquidation value. If they were to sell all their land, collect their receivables, and sell all of their inventory, shareholders would receive more in a liquidating dividend than they can currently pay for the company in the market. However, Scheid is not likely to close down its doors, as they are just beginning to see success in selling their own brands. Therefore, it is best to look at the liquidation value as the floor price Scheid should trade for and use another method to value them as a going concern.

Liquidation value:

Three comps within the Greenfield area suggest that the price per acre of a vineyard is around $43,877.87. We will apply this to value all the land that they own, including the three parcels that were recently rezoned (however, these parcels will likely demand a higher price per acre in the market due to the zoning change).

Item	**Value**
Land (2,249.84 Acres)	98,718,179.58
Winery (@ Original Cost)	46,324,000.00
Cash	1,761,000.00
Note Receivable	3,697,000.00
Inventory	60,133,000.00
Trade & Other Receivables	11,764,000.00
Asset Value	**222,397,179.58**
Less: Total Liabilities	124,935,000.00
Liquidation Value	97,462,179.58
S/O	883,086.00
Liquidation Value per Share	**$ 110.37**

$110.37 represents a 44% upside from the current price of $76.50.

On top of this, management gave the 2018 appraisal value of the vineyards and winery that they own. They did not include the parcels that were recently rezoned.

Item	**Value**
2018 Appraised Value of Vineyards & Wi	190,540,000.00
Cash	1,761,000.00
Note Receivable	3,697,000.00
Inventory	60,133,000.00
Trade & Other Receivables	11,764,000.00
Asset Value	**267,895,000.00**
Less: Total Liabilities	124,935,000.00
Liquidation Value	142,960,000.00
S/O	883,086.00
Liquidation Value per Share	**$ 161.89**

$161.89 represents a 111% upside from the current price of 76.50. The major difference between my own appraisal value and the appraisal given by management is likely the value of the Greenfield winery building, which I simply valued at original cost.

The reasons for this material mispricing is due to Scheid recently coming out of the dark and the illiquidity of the company's shares.

Scheid will demand a much higher price per share if they are successful at implementing its business transition from a seller of bulk wine to a seller of cased wine. The following valuation assumes the winery operates at 90% capacity and the average price per case sold is $50. I applied a 15x multiple, which is on the lower end of the PE that Willamette Valley Vineyards Inc (WVVI), a very similar winery to Scheid, demanded over the current market cycle.

Item	**2025**
Sales	$ 90,000,000.00
Gross Margin	*60.00%*
Gross Income	54,000,000.00
SG&A %	*35.00%*
SG&A	31,500,000.00
Interest	5,663,000.00
Operating Income	$ 16,837,000.00
Tax Rate	*40%*
Taxes	6,650,615.00
Net Income	$ 10,186,385.00
S/O	883,086.00
EPS	**11.53**
P/E Multiple	15.00
Price	**$ 173.02**

This price represents a compound annual return of 14.5% per year from now to 2025.

There are a few catalysts in place that will help Mr. Market realize Scheid's true value. The first is the sale of the rezoned properties. The second is continued cased wine sales and direct to consumer sales growth. Scheid's 2018 gross margin was extremely low, but this is likely an outlier and I expect that it will expand significantly as they sell more cased wine due to the higher price point at which they will be able to sell the wine.

Scheid is trading significantly below what a private buyer would pay for the entire company. It is a classic "heads I win, tails; I don't lose much" situation because the land they own protects the downside and the strategy that they will continue to execute provides an opportunity for significant upside.

Disclosure: Long SVIN. No position in any other securities mentioned within the above article.