COMMENTARY

May 15, 2009

Dear clients and colleagues,

Assessing the real asset value

It's not uncommon to experience market phases like the one we are in right now, when investors choose riskier assets (driven by short-term speculation) over more secure ones. Fundamentals have little meaning in such periods, leaving very interesting stories deeply undervalued. Regardless of the industry, we occasionally observe good money creation potential from exceptional misunderstood stories. In some cases, market value is ridiculously far from reflecting a more realistic value.

All industries should be analyzed differently. Along with our discounted cash flow analysis, we make sure to consider factors that characterize each industry. Macro and micro factors, such as consumption trend and cost structure, might impact two businesses operating in the same industry differently. Baron de Ley, a premium-wine producer in Rioja, is a good example of a misinterpreted company. We define premium wines as a product with a selling price that ranges from €5-€15/ 0.75 liter.

The market currently values this company at €187M (€30/share). One might justify this market price by arguing that the Spanish economy is hardly hit by the recession and people are scaling down premium products, turning to more value-priced wines. Although we are aware of this situation, we feel like other meaningful macros are ignored. While the overall market share for premium wine is small (5% to 30% depending of the country), the category is growing faster than non-premium wines. Certainly, during recessions, premiums faced slower demand, but historical data shows that after a year or so, premium products return to their normalized growth. Also, consumption level per capita in larger-growing markets (US, Russia, China, UK…) is very low and the trend is constantly aiming upward. Not only is premium wine consumption, in our opinion, not about to stop, we must remember that Rioja producers such as Baron are the only ones in Spain allowed to label their products D.O.C., the highest qualified designation of origin.

Based on a liquidation value approach, we realize how depressed the stock price is. Analyzing wineries is very different from other consumer staples companies; one important differentiation to keep in mind is that inventories appreciate over time. At Baron, the selling price varies between €5 and €17, depending of the category: *crianza* (aged 2 years), *reserva* (aged 3 years), or *grand reserva* (aged 5 years). Baron has approximately 90M bottles on hand. Assuming a selling price of €5/bottle and using a cost-value basis to appraise the remainder assets, we arrive at a net enterprise value of €456M (€74/share). Our DCF model gives a similar value of €62/share. Thus, we feel very comfortable assessing an average value of €68/share for this winery. We insist on the very conservative assumptions behind our numbers: low selling prices, cost-based value for its 750 ha of land (Rioja region has the most expensive soil in Spain) and a highly discounted value for its state-of-the-art machineries. This year will certainly be a challenging one but at this current market price, we expect to at least double our money in the next few years.

With 39 years of experience, Baron has received many awards over the years. Year after year since 1997, one of its blockbuster products, *El Coto*, is the top selling product in Spain. Moreover, Wine Spectator ranks most of its products in their top 12%. One way to safely invest your dollar can be to let it sleep into the wine cave and wait a few years. This is certainly more appealing than leaving your dollar in a low-interest bearing account.

Regards,

David Savignac
Assistant portfolio manager