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Wine Lovers, Look At This Oregon Vineyard From A Buy-And-Hold Investor's Point Of View

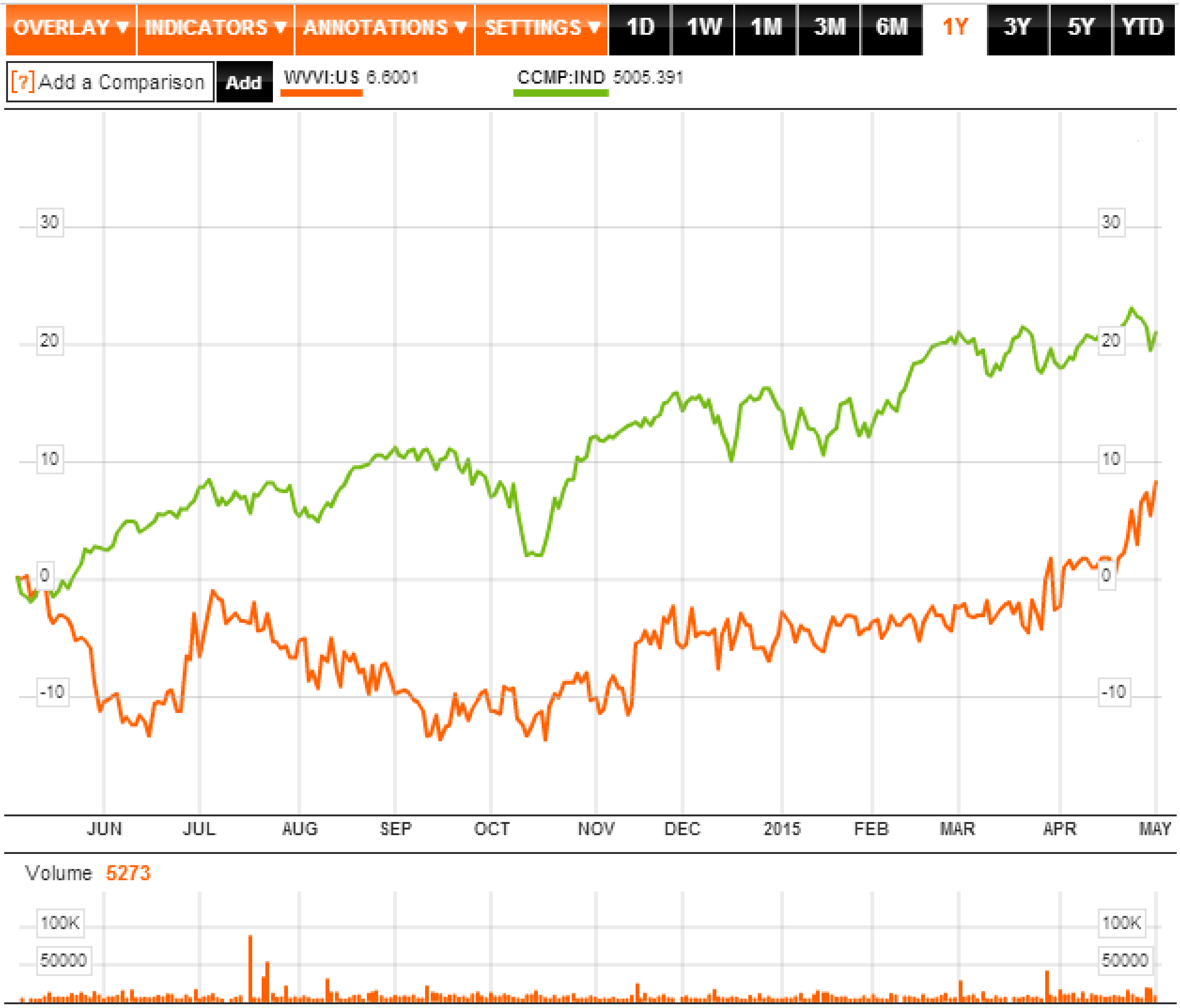
May 5, 2015

Summary

- Willamette Valley Vineyards, Inc. is based in Oregon. The fine winery has been operating since 1980s.
- The founder of the company together with experienced personnel keeps driving the business towards operational and financial success. Insiders own 23% of total equity.
- My DCF model, based on rather conservative assumptions, shows that the company is currently undervalued. I expect extra premium coming from multiples expansion.

My next stock of interest belongs to the micro-cap section of the market. Hence, beware of the risks associated with investing in such securities (e.g. low liquidity, high non-systematic risks, etc.). With only four articles dedicated to Willamette Valley Vineyards, Inc. (NASDAQ:WVVI), the company is extremely underfollowed and under-researched. Currently, there are no official analyst ratings for the company.

In the meantime, Willamette Valley Vineyards has grown EBITDA by 30% in 2014 on a year-over-year basis on the back of a 14% increase in revenues. The $38M company has posted revenues of $15.2M in 2014 and delivered EBITDA of $4.3M. The stock has incredibly underperformed the broader NASDAQ index in the last 12 months despite its operational progress:



(Source: Bloomberg)

Jim Bernau started the company back in early 1980s, working by himself on a 1000 sq. ft. ex-plum orchard. He ploughed the land on a small tractor and used a garden hose to water the entire area of the land. Jim spent next several years learning more about the winemaking business in Burgundy, France and by attending University of California (Davis campus). In 1989, his winery was ready to begin production of Pinot Noir, Chardonnay, and Pinot Gris. Now, the company includes three additional vineyard sites: Tualatin estate, Hannah Vineyard, and Elton Vineyards:




The company also purchased Loeza Vineyards near Gaston, Oregon in 2014. The following table summarizes Willamette Valley Vineyards' land properties:

	ACRES					TONS	
Vineyard Name	Total	Producing	Pre-Production	Plantable	Non-Plantable	Harvest 2014	Harvest 2013
Owned Vineyards							
WVV Estate	107	57	11	2	37	227	141
Tualatin Estate Vineyards	107	51	9	-	47	251	130
Ingram Vineyards	86	-	62	-	24	-	-
Loeza Vineyards	62	-	-	58	4	-	-
Sub-Total	362	108	82	60	112	478	271
Leased Vineyards							
Peter Michael Vineyards	79	69	-	-	10	341	254
Meadowview Vineyards	45	45	-	-	-	189	127
Elton Vineyards	59	54	-	2	3	203	97
Ingram Vineyards	109	-	-	109	-	-	-
Sub-Total	292	168	-	111	13	733	478
Contracted Vineyards*							
Various	216	216	-	-	-	970	1,020
Total	870	492	82	171	125	2,181	1,769

* Contracted acreage is estimated

(Source: 2014 Annual Report)

Note: the value of the real estate is subject to further analysis, not included in this valuation article.

The Company owns and leases approximately 654 acres of land, of which 529 acres are currently planted as vineyards or is suitable for future vineyard planting.

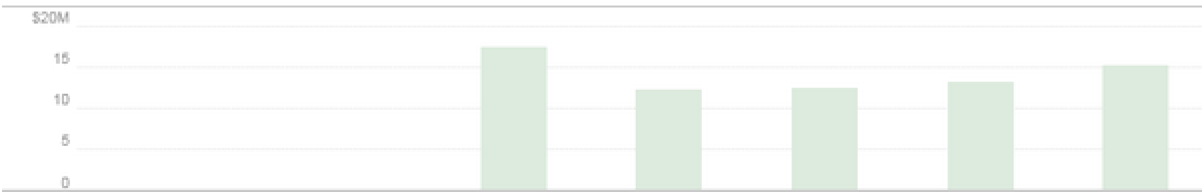
"The Winery is 12,784 square feet in size and contains areas for processing, fermenting, aging and bottling wine, as well as an underground wine cellar, and administrative offices. There is a 12,500 square foot outside production area for harvesting, pressing and fermenting wine grapes, and a 4,500 square foot insulated storage facility with a capacity of approximately 30,000 cases of wine. The Company also has a 23,000 square foot storage building to store its inventory of bottled product with a capacity of approximately 135,000 cases of wine" (Source: 2014 Annual Report).

The properties have a total production capacity of 132,000 cases of wine (314,000 gallons or 11,886 hectoliters). The company plans to produce 120,100 cases in 2015 (an increase of 11.8% from the 2014 record). In addition to the production capacity discussed above, the Tualatin Winery adds approximately 25,000 cases of capacity to the company.

Throughout the years, Mr. Bernau built a total team of 122 full- and part-time winemaking professionals. The operations of the business are in hands of a relatively young but educated and experienced team of winemakers.

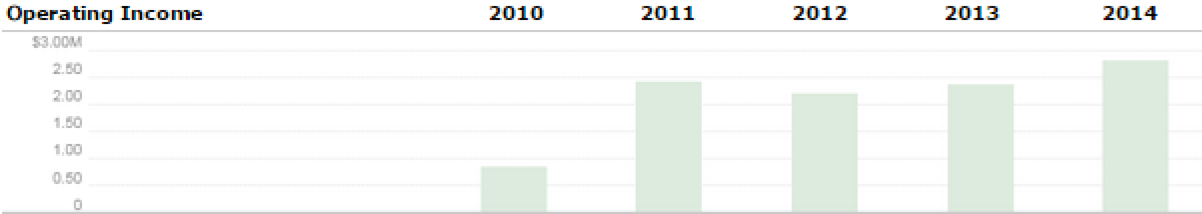
Historical Financials

The last five years of financial data have been provided by TD Waterhouse:



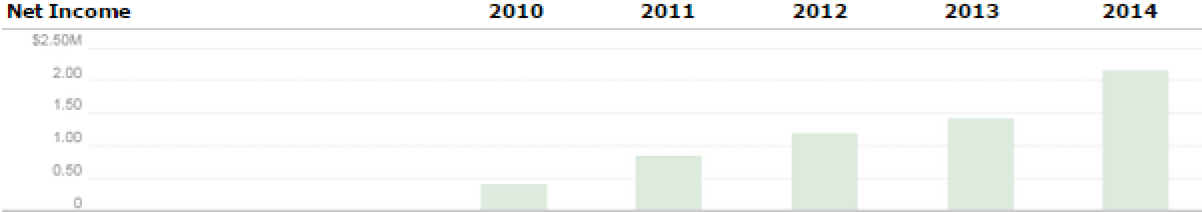
Total Revenue	2010	2011	2012	2013	2014
Revenue	$17,371	$12,236	$12,527	$13,272	$15,156
Total Revenue	**17,371**	**12,236**	**12,527**	**13,272**	**15,156**

OPERATING INCOME



Operating Income	2010	2011	2012	2013	2014
Cost of Revenue, Total	$10	$5	$5	$6	$6
Gross Profit	**8**	**7**	**7**	**8**	**9**
Sell/Gen/Admin Expenses, Total	7	5	5	5	6
Operating Income	**1**	**2**	**2**	**2**	**3**

NET INCOME



Net Income	2010	2011	2012	2013	2014
Interest Expense, Net Non-Op	$(192)	$(217)	$(232)	$(245)	$(289)
Interest/Inv. Income - Non-Op	13	13	9	7	1
Other, Net	18	77	125	192	419
Net Income Before Taxes	**685**	**2,293**	**2,100**	**2,328**	**2,937**
Provision for Income Taxes	273	860	739	905	776
Total Extraordinary Items	--	(575)	(157)	0	--
Net Income	**412**	**858**	**1,203**	**1,423**	**2,161**
Income Avail. to Com Excl ExtraOrd	**412**	**1,433**	**1,360**	**1,423**	**2,161**

TOTAL CASH - OPERATIONS

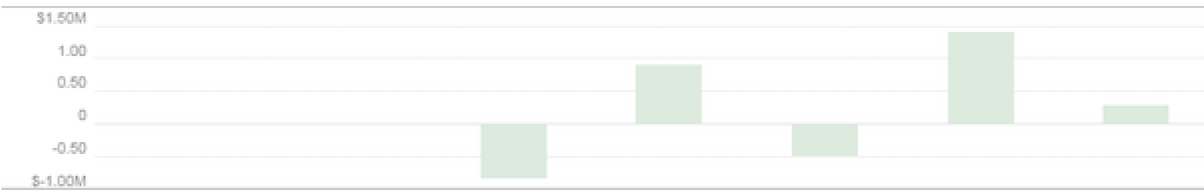
Cash from Operating Activities	2010	2011	2012	2013	2014
Net Income/Starting Line	$0	$1	$1	$1	$2
Depreciation/Depletion	1	1	1	1	1
Deferred Taxes	0	0	(0)	0	(0)
Non-Cash Items	(0)	1	1	(0)	(0)
Account Receivable	1	(1)	0	(0)	(0)
Inventories	1	0	(0)	(1)	(0)
Prepaid Expenses	(0)	(0)	0	(0)	0
Other Assets	--	0	0	0	--
Accounts Payable	(0)	(0)	0	(0)	0
Accrued Expenses	0	(0)	0	(0)	0
Taxes Payable	--	0	0	(0)	0
Other Liabilities	(0)	0	0	0	0
Changes in Working Capital	2	(1)	1	(1)	(0)
Cash from Operating Activities	**3**	**3**	**3**	**2**	**3**

(click to enlarge)

TOTAL CASH - INVESTING

Cash from Investing Activities	2010	2011	2012	2013	2014
Capital Expenditures	$(1)	$(2)	$(2)	$(7)	$(4)
Sale of Fixed Assets	0	0	0	0	0
Other Investing Cash Flow	0	0	0	0	0
Other Investing Cash Flow Items, Tot.	0	0	0	0	0
Cash from Investing Activities	**(1)**	**(2)**	**(2)**	**(7)**	**(4)**

TOTAL CASH - FINANCING



Cash from Financing Activities	2010	2011	2012	2013	2014
Financing Cash Flow Items	$0	$(0)	$0	$(0)	$0
Issuance (Retirement) of Stock, Net	0	--	(0)	0	0
Issuance (Retirement) of Debt, Net	(1)	1	(0)	2	(0)
Cash from Financing Activities	**(1)**	**1**	**(0)**	**1**	**0**
Net Change in Cash	**2**	**2**	**1**	**(4)**	**(0)**
Net Cash - Beginning Balance	**0**	**2**	**3**	**5**	**1**
Net Cash - Ending Balance	**2**	**3**	**5**	**1**	**1**

Financial Projections

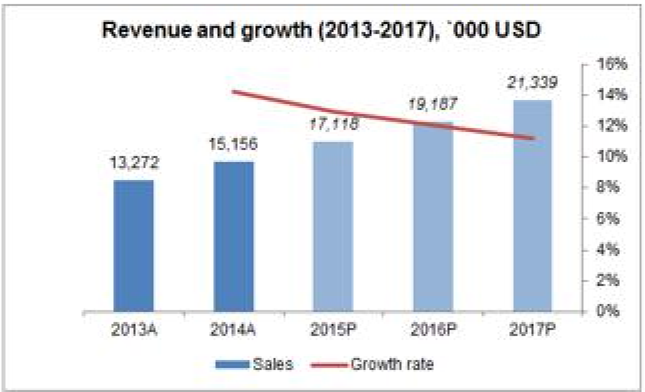
It was quite difficult for me to build operational projections without any guidance from the management but I managed to do it. My primary assumption is that the company will reach its production capacity of 132,000 cases of wine by the end of 2017. This signifies a total increase in production of 23% since the record of the last fiscal year.

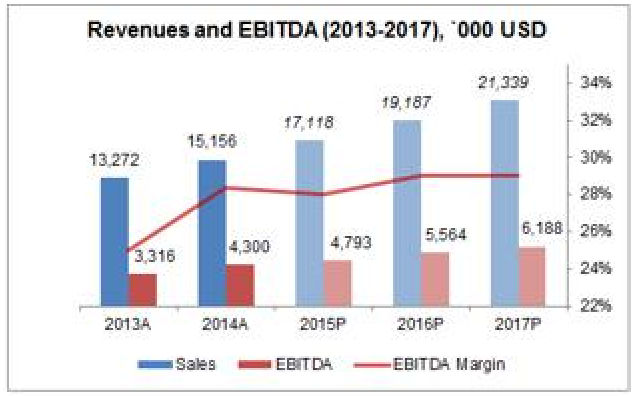
My projected income statement looks as follows:

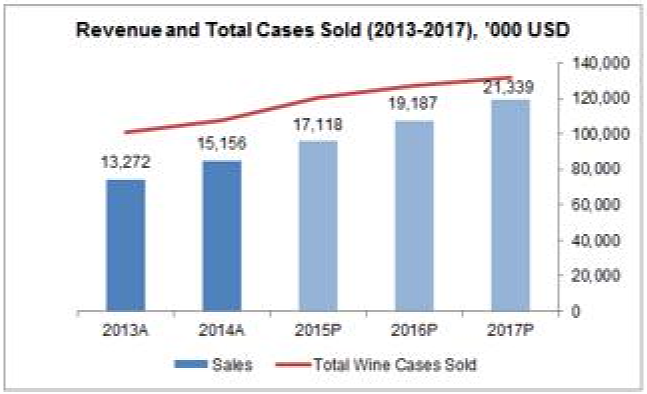
In '000 USD	2013A	2014A	2015P	2016P	2017P
Sales	13,272	15,156	17,118	19,187	21,339
Growth rate		*14%*	*13%*	*12%*	*11%*
Cost of Sales	(5,588)	(6,140)	(6,847)	(7,483)	(8,109)
Margin	*42%*	*41%*	*40%*	*39%*	*38%*
Gross Profit	7,683	9,017	10,271	11,704	13,230
Margin	*58%*	*59%*	*60%*	*61%*	*62%*
SG&A	5,309	6,210	6,676	7,483	8,536
Margin	*40%*	*41%*	*39%*	*39%*	*40%*
EBITDA	**3,316**	**4,300**	**4,793**	**5,564**	**6,188**
EBITDA Margin	*25%*	*28%*	*28%*	*29%*	*29%*
D&A	749	1,075	1,198	1,343	1,494
Margin	*6%*	*7%*	*7%*	*7%*	*7%*
EBIT	**2,567**	**3,225**	**3,595**	**4,221**	**4,695**
Margin	*19%*	*21%*	*21%*	*22%*	*22%*
Interest Income	7	1	1	1	1
Interest Expense	(245)	(289)	(289)	(289)	(289)
Income Taxes	(905)	(776)	(1,290)	(1,534)	(1,719)
Tax rate			*39%*	*39%*	*39%*
Net Income	**1,423**	**2,161**	**2,017**	**2,399**	**2,688**
Growth rate		*52%*	*-7%*	*19%*	*12%*
Total Wine Cases Sold	**100,500**	**107,400**	**120,100**	**127,000**	**132,000**
Growth rate		*6.9%*	*11.8%*	*5.7%*	*3.9%*
Revenue per case	$132	$141	$143	$151	$162
Growth rate		*14.2%*	*1.0%*	*6.0%*	*7.0%*

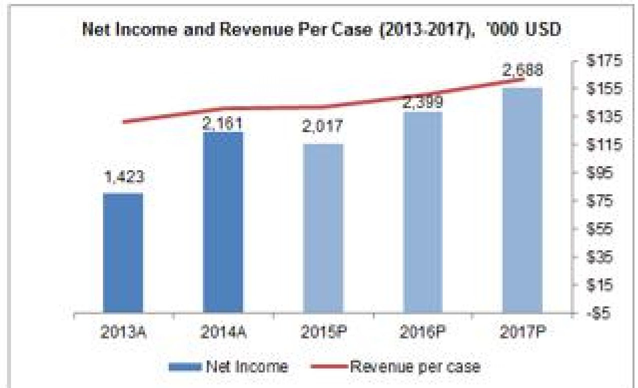
(Source: DCF Model)

To illustrate the key data graphically, I built the following charts:









(Source: DCF Model)

Key observations:

1. The revenue growth rate in 2014 was 14%. I project revenues to grow by 13% in 2015, by 12% in 2016, and by 11% in 2017. I think that these estimates are incredibly conservative because sales volumes only are expected to grow by 11.8% in 2015, 5.7% in 2016, and 3.9% in 2017. In contrast, more than 50% of the revenue growth in 2014 (+14%) is explained by a 7.3% increase in price per case. Hence, increases of 1% in 2015, 6% in 2016, and 7% in 2017 are in line with the previous years' data.

2. EBITDA is expected to increase to 29% of revenues in 2016 and stay at this level through 2017. I think that the 100 basis points growth is very conservative: the margin expanded by 300 basis points in 2014 only. The main drivers of the margin expansion will be the growth in production (increase in scale of operations) and the rise in price per case.

3. Net income is expected to decrease modestly in 2015, despite the anticipated 11% growth in EBITDA, due to the increase in the effective tax rate, which was 26.4% in 2014. "The provision for income taxes and the Company's effective tax rate was $904,709 and 38.9%, respectively of pre-tax income in the year ended December 31, 2013. This decrease in the Company's income tax provision is primarily related to tax deductions for domestic production activity and federal and state tax credits related to the Company's recent facility expansions and remodels. The Company does not anticipate similar credits in future periods" (Source: 2014 Annual Report).

From the above readers can see that I have been fairly conservative in my expectations regarding the company's next three years of operations.

DCF Valuation

Modeling the next three years' cash flows was even more challenging for me than projecting the income statement. Nevertheless, I believe that I built it using the most reasonable assumptions backed by conservative estimates. The key building blocks of the model are given below.

EBITDA: I expect the next three years' EBITDA margin to be at **28**% in 2015,**29**% in 2016, and **29**% in 2017. As I said before, the margins are extremely conservative relative to historical records. With projected revenues of $17.1M in 2015 (13% more than the sales figure for 2014, net of excise tax), $19.2M in 2016, and $21.3M in 2017, the corresponding values are **$4.8**M, **$5.6**M, and **$6.2**M, respectively.

EBITDA Multiple: I used an EBITDA multiple of **8.5X**, which is the current implied multiple based on the current enterprise value and the last twelve months' EBITDA figure.

1. For the bear scenario, I used an **8X** multiple to factor an extra 6% market correction
2. In the most optimistic scenario, I used a **9X** EBITDA multiple.

Tax Rate: 39% in the next three fiscal years.

CAPEX: I used CAPEX figures of **$4**M in fiscal 2015, **$4.3**M in 2016, and**$4.6**M in 2017. Annual increases in capital expenditures of around $300K are in line with historical figures. Besides, a margin of error is always welcome.

Depreciation and Amortization: at the level of $**1.2**M in 2015, $**1.3**M in 2016, and $**1.5**M in 2017. These figures are based on the last year's percentage of revenues dedicated to this expense (**7**%).

Net Working Capital: I do not expect large swings in current assets or current liabilities relative to the value of current accounts or in relation to revenues. Hence, I made NWC changes equal to zero for the next three fiscal years.

Debt: The company carries $**5.53**M of debt on its balance sheet. With the cash balance of ~$**520**K the net debt figure is equal to approximately $**5.0**M. The company incurred an interest expense of $289K in fiscal 2015. At the tax rate of 39%, the after-tax cost of debt is at **3.5**%. Please note that the interest expense may grow because the company intends to use the $2M undrawn credit facility for capital expenditures in the next two years, and the cost of debt may change.

WACC: The cost of equity is equal to **4.4**%: I used the Capital Asset Pricing Model to calculate this figure. I put together a **2.11**% risk-free rate (current yield on US 10-year bond), a 5-year beta of **0.39**, and a market equity premium of **5.75**% (data provided by professor Aswath Damodaran of NYU Stern School of Business). With equity representing **85**% of the company's market value of capital and debt taking **15**% of the capital structure, I calculate the weighted-average cost of capital to be **4.2**%.

On the other hand, because the company is considered an ultra-cap, I recommend requiring at least a 10% return on equity: "Return on ultra-small caps has been 13.4% over the past 5 years and 8.58% over the past 10 years" (Source: Dow Jones Indices).

With these inputs, the model produces the following results:

Total Enterprise Value

		Terminal EBITDA Multiple		
		8.0x	8.5x	9.0x
Discount	3%	$44.2	$47.0	$49.8
Rate	4%	42.9	45.6	48.3
(WACC)	5%	41.7	44.3	47.0

Total Equity Value

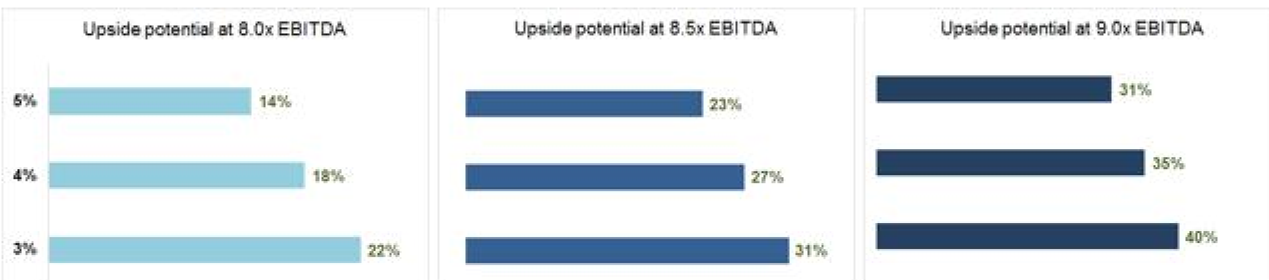
		Terminal EBITDA Multiple		
		8.0x	8.5x	9.0x
Discount	3%	$39.2	$42.0	$44.8
Rate	4%	37.9	40.6	43.4
(WACC)	5%	36.7	39.3	42.0

Implied Perpetuity Growth Rate

		Terminal EBITDA Multiple		
		8.0x	8.5x	9.0x
Discount	3%	4.1%	4.0%	4.0%
Rate	4%	5.1%	5.0%	5.0%
(WACC)	5%	6.1%	6.0%	6.0%

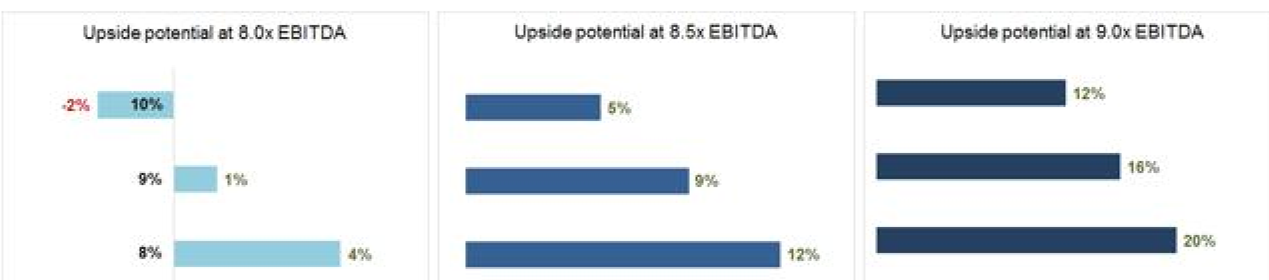
Total Price Per Share

		Terminal EBITDA Multiple		
		8.0x	8.5x	9.0x
Discount	3%	$7.94	$8.51	$9.09
Rate	4%	7.69	8.24	8.80
(WACC)	5%	7.44	7.98	8.52



(Source: author's own work)

I personally require at least a 10% annual return on my investments. Hence, I used the rate for the cost of equity and obtained the following distribution of upside potential:



(Source: author's own work)

Note: The percentages indicate an upside move required for the stock to reach its fair value.

Readers may see that even at a 10% discount rate the stock is undervalued relative to its fair price.

Opinion

I issue a BUY recommendation for the shares of Willamette Valley Vineyards Inc. with a target price range of $8.00-$8.50 per share. This represents an upside opportunity of 23%-30% by the end of the year. I expect the stock to grow at rates between the one required by the Capital Asset Pricing Model and the historical return on equity for the next two years post 2015.

Note that because the stock is under-researched by major banks and brokerage houses there room for a significant multiple expansion: with a P/E ratio of only ~15X the stock is substantially undervalued relative to the market in general (S&P 500 currently stands at 20.7x TTM earnings, while NASDAQ is at 23.2x).

P.S. View the company's accolades here.

Editor's Note: This article covers one or more stocks trading at less than $1 per share and/or with less than a $100 million market cap. Please be aware of the risks associated with these stocks.