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Scheid Vineyards Inc.

(OTC: SVIN: $67)

Scheid Vineyards trades at a 67%+ discount to my Net Asset Value (NAV) calculation of over $200 per share. How is it possible to buy a company at such a significant discount to NAV? Mainly, because few people know that Scheid Vineyards exists. Eleven years ago, the company went "dark" and stopped filing financials with the SEC and the stock has been languishing in obscurity ever since. In addition, the company trades only about 500 shares a day. In many ways, Scheid is practically a private company. However, there aren't many private companies you can buy into for such enormous discounts to a reasonable valuation.

Scheid is actually starting to come out of the dark and just started releasing quarterly and annual numbers to investors for the first time in almost a dozen years. As more information comes out, more investors will discover just how undervalued Scheid actually is. My estimate of liquidation value is somewhere between $198 and $241 per share.

Scheid Has Been Growing Grapes for 45 Years and Making Wine for Over a Dozen Years

The origins of Scheid Vineyards can be found not in the love of winemaking, but in tax law. In 1972, Al Scheid, a self-employed investment banker, founded Monterey Farming Corp. to plant vineyards and generate tax losses for a group of wealthy investors. At that time losses generated by development of vineyards were legally deductible from all sources of income.

Over the years, what was once a tax loss play has blossomed into a company with substantial land and vineyard assets in Monterey County, California. By the mid-1990s, Al had bought out the last of his limited partners and took the company public as Scheid Vineyards Inc. The proceeds were used to develop additional vineyards in Monterey.

By about 2002, the market for small cap stocks had all but disappeared. Scheid used internally generated cash to buy in shares, substantially reducing the capitalization. In 2006, frustrated by the costs and regulations of the Sarbanes-Oxley Act, Scheid "went dark," stopped filing financials with SEC or issuing press releases and started trading over the counter (not on any major stock exchange). Until recently, the company has operated in public market obscurity.

Valuable Assets in Monterey County, California

Monterey County, California is about as close to agricultural paradise as it gets. The area's moderate temperatures and reliable water for irrigation make it the perfect environment for many crops. Few may realize that the Salinas Valley area of Monterey County is known as "the

Salad Bowl of America." The area produces 70% of the nation's lettuce and is home to two of the four largest orchid growers in the U.S. There are also 46,000 acres of wine grape vineyards in the county. Monterey produces the most Chardonnay grapes of any county in the United States and is also known for its excellent Pinot Noir wine grapes.

Scheid Vineyards owns or leases the land of close to 4,000 gross acres of vineyards in Monterey County and contract farms another 740 acres for one of the world's largest wine producers. The company also owns and operates a state of the art winery that covers nearly three acres. This facility commenced operations with the harvest of 2005. The capacity has been increased almost annually and most recently expanded in 2016. It processes over 30,000 tons of grapes each harvest, which represents over 2 million cases of wine. The company also owns and operates a small, boutique winery in which its best premium wines are produced. The company has invested over $75 million developing these facilities.

The company is completely vertically integrated. From growing the grapes, to crushing, to fermentation, blending, and on to the bottling and shipping; Scheid does it all. It is important to note that only a few mass market wine producers have similar control from the field to the bottled product. This means Scheid can control quality and quickly react to take advantage of opportunities in the retail wine markets.

Scheid Has Been Growing Its Private Labels

Despite its puny market cap, Scheid is not a tiny company, nor is it a slow growing one. The company posted revenue of $62.3 million in fiscal 2017 (ended February), up 27% from the previous year and up almost 50% from fiscal 2015. Cash flow (EBITDA) jumped 37% to almost $15 million year over year. Net income was up 75% from prior year.

Why? The company has transitioned from just selling grapes and bulk wine to other bottlers, to creating its own brands and private label brands for retailers. Scheid has partnered with several large retail chains to create wine labels that are exclusive to that retailer. For example, there are brands that are exclusive to the largest grocery chain in the U.S.

Another example is a partnership with the famous TV personality, Kathy Lee Gifford - called GIFFT - which Kathy Lee promotes. And, if you are in first class on one of the largest airlines in the world, you are likely drinking Scheid Vineyards wine made just for that airline - you just wouldn't realize it.

Specifically, Scheid is producing the quality of a $20+ bottle and then delivering it into retail for a $12-$16 price point. And it is proving to be very, very successful. This segment of the business has grown from $8 million to $23 million in annual revenue in just two years. Scheid also produces high quality wines that retail for up to $70 per bottle.

Retailers are clearly loving the private label strategy, as it enables them to capture some of the margin that they have been giving up to branded wine companies. The private label business has become so important to grocers that Kroger is suing competitor Lidl for trademark infringement, since the Lidl chain private label name sounds too close to Kroger's "Private Selection." While it is easy to make private label deli meats, paper goods and other basic commodity items, it is much more difficult to develop a private label wine. Scheid comes up with the government approved label, wine type and marketing campaign for the retailer. Since Scheid is in control, vineyard to bottle, they can guarantee quality, volume, price and reliable delivery. The largest wine producers don't compete for this business since they have their own brands to produce and promote.

The trend to private labels should not stop any time soon. What makes Scheid so compelling as a partner is that there are very few vineyards that are vertically integrated and have the capacity to provide new wines and labels. Scheid can process wine equal to 2 million cases, but its own branded wines used up only 500,000 cases of that volume in 2016. The rest of the 2016 volume was sold as bulk wine to other wineries or went into private labels.

So far in fiscal 2018 (calendar year ends in February), sales are down due to bulk wine sales. They had excess inventory from past bumper crops that caused sales to fall for their first six months of the year. The bulk wine segment will be choppy from year to year, but the focus for Scheid is on the cased goods business.

Worldwide Wine Production to Hit a 50-Year Low

This is a great time to invest in the wine industry due to rather dramatic declines in global wine production volumes to levels not seen in 50 years. Due to extreme weather in France, Italy and Spain, worldwide production is estimated to fall 8% in 2017. France is facing its worst harvest since 1945 with production volumes down 19%.

Wine volumes in the U.S. are estimated to fall 1% and this is before the small effect from the recent fires in Northern California. Wineries there had already harvested most of their grapes when the fires hit.

Over the next 12 to 24 months, wine prices should increase as the industry struggles to meet demand because of such large decreases in this year's production. This bodes very well for Scheid over the next two years as the company grows its cased goods business. While the impact may not be immediate, it provides a nice backdrop and tailwind for the company.

Forward Cash Flow Valuation Potential

I estimate that the company should be able to grow revenue in the next three years to $80 million in fiscal 2020, and $100 million by 2022. Obviously, these numbers are contingent on continued growth in Scheid's own labels and the private label business.

Scheid is investing in staff and infrastructure to support continued growth. The company just announced a new wind turbine which will power the winery compound and lower energy costs.

(Watch the video here: https://www.youtube.com/watch?v=lnNzLKgS_fk&feature=youtu.be)
Other additions include the hiring of a purchasing manager, who will be responsible for driving down the cost of materials and supplies. The company is also increasing distribution via an aggressive social media sales program, staffed by new hires.

For the next couple of years, it is definitely a guess as to what earnings will look like, as it will depend on how aggressively the company invests into their operations. Scheid Vineyards is plowing back their cash flow back into the company to build long term value.

Assuming the company's EBITDA margin stays in the range of 23-25%, by 2020, Scheid Vineyards could produce cash flow of approximately of $21 million or $24 per share. That said, the margins should be able to increase as the company scales, it all depends how much the company invests in their infrastructure.

Considering the current stock price of $67 per share and the market cap of $59 million, Scheid's valuation seems woefully underpriced.

Scheid Stock Is Cheap

Scheid's book value is $46.5 million, or $52.70 per share based on 882,586 shares currently outstanding. But the book value doesn't even come close to telling the story of the value of the company's assets, due to land appreciation and depreciation accounting.

The company owns the land underlying 1,892 acres of vineyards. Based on calls to a well-known vineyard broker and appraiser in Monterey County, vineyards sell in the range of $40,000 to $60,000 an acre. So, just on vineyards alone, Scheid has an asset value of $76 million to $114 million.

As a comparison, prices in the prized Santa Lucia Highlands area of Monterey County prices top $75,000 an acre. Napa and Sonoma vineyards trade for $140,000 to $160,000 an acre. Wineries, such as those in Napa and Sonoma, are legally permitted to blend in up to 15% of wine or grapes produced in other districts and still label them as Napa and Sonoma wines. This is one reason Scheid has a ready-made market for both grapes and bulk wine. There is even a fascinating argument to make that Monterey County land is undervalued, since so many Napa and Sonoma labels use Monterey County grapes in their wine.

Scheid's state of the art winery facility is also quite valuable. There is a strong case to make that it is worth more than its $75 million construction cost, but to be conservative let us assume that it is worth only the $75 million. That is roughly equal to its total debt.

The company also owns 123 acres of non-vineyard farm land next to Greenfield, CA that is in the process of being annexed and re-zoned for residential and commercial development. I value this land, after annexation, at $150,000 an acre. This adds an additional $18.5 million in value.

Now, if we just add the company's land holdings and winery facility value, we get a gross valuation of $169 million to $205 million.

Scheid also owns the vineyards on 1,842 acres of long term leased land. According to Crimson Wine Group (NASDAQ: CVGW), an investment of $25,000 to $75,000 in capital improvements is necessary to get a vineyard into production. For purposes of Scheid's valuation, I took a conservative approach and assumed a vineyard value of $20,000 per acre. The 1,842 acres adds about $37 million in value.

Since wine is produced only one time per year, the company currently holds $49 million in inventory at cost.

The company has $80 million in debt with Rabobank. The two debt instruments have a blended average 3.76% and 3.86% interest, reflecting the high quality of the company's credit.

Subtracting out the debt of $80 million, here are the range of valuations. Remember there are 882,586 shares outstanding. Even with its low liquidity, Scheid's per share undervaluation is extreme.

Scheid Vineyards Value Analysis								NAV
per acre	$ value	+ resi rezoned	+inventory	+winery	+leasehold	-debt	Total	per share
$ 40,000	$ 75,680,000	$ 18,450,000	$ 49,226,000	$ 75,000,000	$ 36,840,000	$ 80,766,000	$ 174,430,000	**$ 198**
$ 45,000	$ 85,140,000	$ 18,450,000	$ 49,226,000	$ 75,000,000	$ 36,840,000	$ 80,766,000	$ 183,890,000	**$ 208**
$ 50,000	$ 94,600,000	$ 18,450,000	$ 49,226,000	$ 75,000,000	$ 36,840,000	$ 80,766,000	$ 193,350,000	**$ 219**
$ 60,000	$ 113,520,000	$ 18,450,000	$ 49,226,000	$ 75,000,000	$ 36,840,000	$ 80,766,000	$ 212,270,000	**$ 241**

Publicly Traded Comps

Another valuation approach is to compare Scheid to other publicly traded wine companies. There are three comparable companies I used: Crimson Wine Group (NASDAQ: CWGL), Treasury Wine Estates (OTC: TSRYY), Willamette Valley Vineyards (NASDAQ: WVVI).

Crimson Wine Group and Willamette Valley are probably the best comparables. Crimson owns vineyards in Napa and Sonoma County and was a spin-off from Leucadia National (NYSE: LUK). It is treated almost like a private company, trades an average of less than 8,000 shares a day and is closely held. Willamette is an Oregon based vineyard that is also illiquid, trading only 7,000 to 8,000 shares a day.

Treasury is an Australian based wine conglomerate that has a $9 billion market cap. It probably is not the best comp, but I included it in my analysis because it shows what kind of multiple the market gives companies that are growing and performing.

The chart below shows that Scheid has about the same revenue as Crimson, 3 times the revenue of Willamette, but the valuation is very different in every respect.

Company	Treasury Wine Estates	Crimson Wine Group	Willamette Valley	Scheid Vineyards	
Ticker	TSRYY	CWGL	WVVI	SVIN	
Price	12.44	$ 10.45	8.29	$ 67.00	
Shares outstanding	736,620,000	24,000,000	5,006,000	882,586	
Market Cap (millions)	$9,163,552,800	$ 250,800,000	$ 41,499,740	$ 59,133,262	
Debt	$221,470,000	$ (8,000,000)	$700,000	$ 80,766,000	
Enterprise Value	$ 9,385,022,800	$ 242,800,000	$ 42,199,740	$ 139,899,262	
Book value	$2,732,860,200	$ 208,305,000	$ 34,632,000	$ 46,511,000	
Tangible Book	$1,940,330,742	$ 192,679,000	$ 34,632,000	$ 46,511,000	
Revenue LY (millions)	$1,930,000,000	$ 63,690,000	$ 19,425,000	$ 62,255,000	
EBITDA	$395,300,000	$ 10,670,000	$ 5,724,000	$ 14,578,000	
Net Income	$192,230,000	$ 3,800,000	$2,629,975	$ 2,930,000	Avg
P/Sales	4.7	3.9	2.1	0.9	3.6
EV/Sales	4.9	3.8	2.2	2.2	3.6
P/Book	3.4	1.2	1.2	1.3	1.9
P/TBV	4.7	1.3	1.2	1.3	2.4
EV/EBITDA	23.7	22.8	7.4	9.6	18.0
Owned Acres	?	972	534	1892	
Leased Acres	?	19	293	1842	
Total Acres	?	991	827	3734	
EV/Owned Acres	NA	$249,794	$79,026	$73,943	$ 164,410
EV/Total Acres	NA	$245,005	$51,027	$37,466	$ 148,016
P/E	48	66	16	20	43.1
Net Margin LY	9.96%	5.97%	13.54%	4.71%	
SVIN implied value					
	Multiple	**Implied Price/share**			
EV/EBITDA	18.0	$205			
P/TBV	2.4	$127			
P/E	43.1	$143			
EV/Sales	3.6	$255			
EV/Owned Acre	$164,410	$261			
EV/Total Acre	$148,016	$535			

The lowest comp, price to tangible book value, would put Scheid's value at $127 per share.

Family Control, but Strong Family Management

To understand Scheid Vineyards, you must understand the founder and Chairman, Al Scheid. His resume is impressive and I recommend reading his memoir, *Breaking Out of Beerport*. It is a great read. Al is a born story teller and the book has garnered very favorable reviews.

https://www.amazon.com/Breaking-Out-Beerport-Al-Scheid-ebook/dp/B00PIXH408/ref=sr_1_2?s=books&ie=UTF8&qid=1500061558&sr=1-2&keywords=al+scheid

You will learn that Al grew up in, and escaped from, a poor coal mining town in Ohio, put himself through college working as a repo man, ranch hand and, finally, as a furniture salesman. He then achieved an MBA from the Harvard Business School in 1959.

Al went on to be an investment banker for E.F. Hutton. He then founded four successful companies; his own investment banking firm, the wine grape farming company, and two biotechnology research companies. He has been in the wine grape and wine business for 45 years and was recently selected as the 2017 Leader of the Year by the California Association of Winegrape Growers, the state-wide winegrower's trade association.

His son, Scott, (BA, Claremont McKenna College) joined the company in 1986, rose through the ranks and is now CEO. Kurt Gollnick, (BS, Cal Poly San Luis Obispo) the COO, joined Scheid in 1988. Heidi Scheid (Al's daughter), (MBA, U of Southern California) is Executive Vice President, oversees sales and has been with the company since 1992. The last family member working for the company is Tyler Scheid (Al's son), (Masters Degree, Colorado State University) who is Special Projects Manager.

This is a family run company for sure, but it is an educated and experienced high functioning one. The proof is in the results. The fact that the management team has been intact for such a long time with no family drama is a definite plus for shareholders. They are long term focused, well financed and plan their moves carefully.

No Shortage of Potential Suitors

Management is quite adamant that they have no plans to sell, but if they ever change their minds there are many potential acquirers who would be interested in the company's assets, brands and capabilities. There are obviously large liquor and wine companies such as Treasury Wine, but there are also fast growing private companies, such as Delicato Family Vineyards, which is now the fourth largest wine company in America. See this recent article about its acquisition spree:

http://napavalleyregister.com/wine/delicato-s-growing-presence-in-the-wine-industry--/article_77ef5d0e-086f-5834-8f9f-f732108ea6b4.html

Institutions, including Harvard's endowment, is also getting in on the action. Harvard has purchased approximately 10,000 acres of central coast California vineyards. The key money quote in the below article is the investor bemoaning the fact that there are no 1,000 acre vineyards of any quality for sale, nor is there anyone with operational expertise as well. Scheid has both.

https://www.winesandvines.com/news/article/192724/Institutional-Investors-Making-Wine-Plays

Beyond larger wine companies, there are many wealthy investors, Silicon Valley magnates or hedge fund managers who would love to own a company like Scheid Vineyards. And Asian investors are increasingly buyers of California vineyards. In 2014, a Chinese private equity firm bought Quixote winery for $29 million. This winery produced only 6,000 to 8,000 cases a year. There are several more purchases highlighted in the article below:

http://www.winespectator.com/webfeature/show/id/50293

As the company's stature grows, the company will attract more and more interest.

Risks

The main risk to investing in Scheid is the stock's lack of liquidity. The company's shares trade on average 500 shares a day and, some days, it doesn't trade at all. In many ways, investing in Scheid is like investing in a private company.

Another risk is that management until recently had little care for the illiquidity or where the stock traded. Their single-minded goal is to grow and build the business. There were few press releases, no quarterly earnings, no investor calls or presentations. And remember, the company doesn't file financial information with the SEC. This means it is hard for anyone to find out or analyze the company as an investment. However, this is changing as the company is starting to send out quarterly and annual earnings with comments.

The third risk is that this is a family controlled company and that there always is the potential of self-dealing, family squabbles, nepotism and other potential risks. But to date, the company has had none of these problems and the company is thriving under the Scheid family's leadership.

On the plus side, as of this writing, there are three outside directors and the company has four regularly scheduled board of director meetings each year and has done this for over twenty years. Also, the company has undergone complete audits from an independent auditing firm (currently, Moss-Adams, LLP, a top 15 accounting firm) for over 25 years, without an adverse opinion. So, the company treats itself as though it were a widely held, SEC reporting entity.

Summary

Warren Buffett has famously said that most investors would be better off if they had a punch card with 10 or 20 holes on it and that was all the investments they could make over the course of their lives. The lesson is to make each investment count and don't sell. I believe Scheid Vineyards could be a "Warren Buffett punch card" investment.

With the shares so undervalued, the long-term performance of the company so exemplary, and the prime California vineyard land asset value, Scheid is a truly special situation with venture capital like returns to the upside alongside substantial downside protection.

Catalysts

- Recognition that this company exists
- Continued growth
- Asset appreciation
- Future dividends after capital investments end
- Acquisition interest by larger companies and wealthy investors