

stock had the exclusive voting right and was listed on the American Stock Exchange, while Class B common had no voting rights but was also listed. The Brown family held 74 percent of the Class A stock and 40 percent of the Class B, and also provided some of the senior officers and directors of the company some of the Class A stock.

Brown-Forman: Product-Market Strategy and Performance

"The production of distilled spirits is a relatively straightforward task. It is marketing skill that is critically important to the survival and growth of firms in this industry," said William Street, senior vice-president. Brown succinctly stated Brown-Forman's product-market strategy in a presentation to the New York Society of Security Analysts on June 29, 1978:

The company's marketing philosophy is to produce and sell high-quality products which retail at prices generally at the upper end of the price scale within whatever category the product is sold. The company is a strong believer in heavy advertising support in order to build brands that have long life cycles with generally higher margins than are found on brands whose consumer appeal is based on price and shorter life cycles.

Brown-Forman's product line included many well-known brands, which were categorized into three groups (see Exhibit 4).

Outside observers suggested that Brown-Forman's special competence was in building brand franchises. For example, the company purchased the Canadian Mist Brand from Barton Brands, Inc., in 1971, "Because we had no significant brand in the Canadian Whiskey market and perceived significant growth in that market," said Brown. By 1978, it was Brown-Forman's largest brand and grew 11.5 percent during 1977 versus 3.1 percent for all Canadian whiskeys. A second example would be the company's investment in the Bolla and Cella brands of Italian wines. The preeminent example of the firm's ability to build premium brand franchises was, however, Jack Daniel's Tennessee whiskey. Brown said,

Jack Daniel's' compounded annual growth rate over the last five years has been between 10 and 15 percent and yet we know from tests in certain markets where we've allowed free supply both this year and last, that the growth has jumped to between 25 percent to 40 percent. I believe we can state without equivocation that Jack Daniel's has the strongest and most loyal consumer franchise of any product in the industry.

What are the reasons for this phenomenal success? Number one, it has been our long-term marketing philosophy that top quality deserves the highest price, and over many years, Jack Daniel's has been the highest priced American whiskey of any significant volume on the market. The brand is probably the only one that by

policy has never granted quantity discounts of any kind. The fact that there has been a supply shortage from time to time has added to the mystique surrounding the label and no doubt has been a factor contributing to long-term sales growth. . . . Jack Daniel's is a unique product. . . . Our advertising over the years has emphasized the character of the distillery and the whiskey it produces. . . . Finally, the most exciting thing for us for the long term is that the big increase in demand, which is on the top of the normal 10-15 percent compounded annual growth, is coming primarily from the youth market. . . . the corporation sees a very healthy, long life cycle ahead for this brand.

A new marketing thrust on the Jack Daniel's brand had been to increase penetration of foreign markets. This campaign would require an expanded marketing organization overseas.

Whereas skillful branding and product positioning could improve the sales performance of a particular product or product group, another factor, product-line mix, would also affect the sales growth of the company in the long run. **Exhibit 5** suggests how demand for distilled spirits had changed during the previous ten years. Regarding the near future, *Value Line* expected sluggish industry growth overall, although "mystique" brands such as Jack Daniel's would continue to grow:

The spirits companies are beset with a number of problems. While the shift to non-whiskeys is firmly entrenched, the white goods (vodka, gin, rum, and tequila) aren't as profitable. . . . Since the overall liquor market hasn't gotten significantly larger, sales penetration by any one product type has come at the expense of another category.

. . . Retail liquor prices have advanced about 15 percent over the last decade while the consumer price index rose 75 percent. Plainly, the industry has been reluctant to raise prices and has preferred to absorb cost increases because of the sluggish volume.

Southern Comfort

The object of Brown-Forman's acquisition interest was Southern Comfort Corporation (Consolidated) and Caligrapo, Inc., producers of Southern Comfort, a unique liqueur. By industry definition, a liqueur is a distilled spirit that contains more than 2 1/2 percent sugar by volume. Generally, a liqueur is produced by adding a syrup or concentrate to an alcohol base. The concentrate gives the liqueur its distinctive flavor. Southern Comfort's concentrate was mixed by a secret formula owned by Caligrapo, Inc. Caligrapo sold the concentrate to Southern Comfort, which purchased alcohol and mixed, bottled, and marketed the liqueur. Southern Comfort employed 22 salesmen; its sales in 1977 were about \$64 million (see **Exhibits 6 and 7**).

Southern Comfort was owned by the estate of Francis E. Fowler, Jr., while Caligrapo was owned directly by his heirs, principally his sons, Francis G. Fowler, III, and Philip F. Fowler. Francis E. Fowler, Jr., had owned Southern Comfort for many years until his death in 1975.⁷ His sons managed the St. Louis company largely from California, where they and their father had chosen to live in recent years. Despite absentee management, the company was regarded as well run and efficient. Plant visits by Brown-Forman employees revealed modern equipment.

Southern Comfort had enjoyed above-average growth in shipments (see Exhibit 8), which was consistent with the general rise in the consumption of liquors shown in Exhibit 5 but surprising in light of market surveys that over half of Southern Comfort's consumers viewed it as a whiskey. Thus, compared with the slow growth of whiskey as a class, Southern Comfort's performance was arresting. It was attributed in part to rock-and-roll singer Janis Joplin, who preferred Southern Comfort. Strengthened channels of foreign distribution also accounted for growth in export sales. Among marketing professionals, it was considered a very strong brand. Southern Comfort had never been sold at a discount by its manufacturer. Its performance notwithstanding, Brown believed that the brand had not been aggressively marketed.

Through an intermediary, the Fowler brothers had approached Brown-Forman to solicit their interest in buying Southern Comfort Corporation and Caligrapo, Inc., for \$94.6 million. Subsequently, Brown-Forman learned that, in recent years, two other major distillers had entertained the possible acquisition of Southern Comfort and had rejected it at that price. At the time of approaching Brown-Forman, the Fowlers were discussing acquisition with no other potential buyers. They seemed sincerely interested in selling to Brown-Forman, primarily because of a perceived fit of Southern Comfort with the Brown-Forman product line. Also, Brown-Forman resembled Southern Comfort in broad outline: a family-run business with a Southern heritage and a record of superior performance.

The Fowlers indicated a willingness to accept cash for the two companies. Through an intermediary, they also suggested two other features of the acquisition. First, Southern Comfort offered to repurchase that property at book value, about \$5.9 million, after the acquisition. Second, they proposed that the acquisition be consummated after January 1979, when they expected Congress to lower the tax rate on capital gains.

Brown contemplated financing \$20 million of the purchase price with cash and financing the balance with bank debt. He estimated that up to \$70 million could be borrowed at a nominal rate of 8 3/4 percent repayable over 7 years semiannually starting the following year. The company would be required to maintain an average compensating balancing of 7 percent on the amount borrowed.

⁷Following the death of Francis E. Fowler, Jr., an independent appraisal in 1977 deemed the fair market value of the common stock of Southern Comfort to be \$120 per share for estate- and inheritance-tax purposes.

Because the proposed transaction would be taxable to the Fowlers, Brown-Forman could write up the value of the assets to the purchase price paid. Brown-Forman's finance department estimated that the purchase price could be allocated as follows:

Intangible assets (amortized over 40 years)	\$55.0 million
Property, plant and equipment (depreciated over 20 years)	12.2
Current assets	<u>27.4</u>
Asking price	\$94.6 million

Fundamentally, however, the attractiveness of the acquisition would rely on the strength of the cash flow from operations. A small team of executives developed a series of revenue, cost, and volume assumptions, which are summarized in Exhibit 9. The recent price history of Brown-Forman's common stock is given in Exhibit 10.

Exhibit 1

BROWN-FORMAN DISTILLERS CORPORATION

Comparative Financial Data, 1978

	American Distilling	Brown- Forman	Heublein	National Distillers	Publicker Industries	Seagram	Hiram Walker
Beta	1.41	1.10	1.71	.79	1.63	1.04	.65
Marginal tax rate	.30	.50	.49	.47	.40	.46	.50
Debt/Equity	1.14	.247	.55	.34	.84	.53	.20
Debt - Cash	.50	.11	.28	.16	.44	.32	.12
Total capital	2.46	1.37	2.16	1.65	2.04	1.76	1.43
Assets/Equity	1.66	1.46	1.80	1.35	1.49	1.22	1.04
Profit/Sales	.012	.073	.035	.052	.005	.038	.069
Price/Earnings	9.4	8.2	9.6	6.5	NMF	8.8	7.7
Dividend Yield at 4/14/78	NIL	.043	.056	.08	NIL	.042	.062
Self-sustaining growth rate	.049	.102	.053	.079	.015	.041	.054
1978 expected sales growth	.02	.09	.06	.08	.04	.07	.06
Market value Book value	.46	1.26	1.53	.79	.63	.75	.77

Notes: (1) The long-term geometric mean risk premium (calculated as the difference between the return on the market portfolio and the long-term return on government bonds) was 5.7 percent. The arithmetic mean risk premium was 8.7 percent.

(2) The yield to maturity of 10-year U.S. Treasury bonds (a proxy for the *ex ante* risk-free rate) was 8 percent. The yield on 90-day U.S. Treasury bills was 7.08 percent.

Source of market premium: R. G. Ibbotson and R. A. Sinquefeld, *Stocks, Bonds, Bills, and Inflation: The Past (1926-1978) and the Future (1978-2000)* (Charlottesville, Va.: Financial Analysts Research Foundation, 1977), Exhibit 28.

Source of financial ratios: *Value Line* (April 14, 1978).

Source of betas: "Security Risk Evaluation," Merrill Lynch Pierce Fenner & Smith, Inc., April 1978.

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BROWN-FORMAN DISTILLERS CORPORATION

Consolidated Statements of Income
(in thousands except per-share amounts)

Years Ended April 30,		
1978	1977	
		Net sales
\$457,071	\$396,176	
310,539	274,733	Cost of sales
		Gross profit
146,532	121,443	
		Selling, advertising, administrative, and general expenses
76,395	69,714	
		Other income (expense):
(2,300)	-	Write-off of intangible asset
1,314	1,760	Miscellaneous, net
		Earnings before interest and taxes
69,151	53,489	
		Interest expense
5,804	6,249	
		Income before taxes
63,347	47,240	
		Taxes on income
32,100	23,500	
		Net income
\$ 31,247	\$ 23,740	
		Earnings per common share
\$ 2.45	\$ 1.85	

Source: 1978 Annual Report

Exhibit 3

BROWN-FORMAN DISTILLERS CORPORATION

Consolidated Balance Sheets
(in thousands of dollars)

April 30

1978	1977	
\$ 8,875	\$ 9,354	Cash
20,797	36,171	Short-term money market investments
59,759	40,446	Accounts receivable, trade
167,142	148,794	Inventories
1,030	1,380	Other current assets
257,603	236,145	Total current assets
6,554	6,494	Investments in associated companies
81,010	74,229	Property, plant, and equipment, at cost:
41,709	38,384	Less accumulated depreciation
39,301	35,845	Net property, plant, and equipment
6,360	4,716	Other assets
18,787	21,671	Goodwill, franchises, brands, and trademarks
\$328,605	\$304,871	Total Assets
		Liabilities and Stockholders' Equity
\$ 5,000	\$ 5,000	Current portion of long-term debt
39,361	32,213	Accounts payable and accrued expenses
11,475	6,659	Accrued taxes
1,650	2,759	Deferred income taxes
57,486	46,631	Total current liabilities
50,000	60,000	9.3% serial notes, less current portion, \$5,000 due each September 1, 1979-1988
2,894	1,226	Deferred income taxes
110,380	107,857	Total liabilities
		Stockholders' Equity
		Capital stock:
11,779	11,779	Preferred 40¢ cumulative, 1,177,948 shares authorized and outstanding
		Class A common stock, voting, issued shares, 4,020,634
1,206	1,206	Class B common stock, non-voting, issued shares, 8,888,105
2,667	2,667	Capital surplus
91,146	91,146	Retained earnings
115,349	94,138	Less common treasury stock, at cost (Class A, 61,742 shares; Class B, 261,377 shares)
(3,922)	(3,922)	Total stockholders' equity
218,225	197,014	Total liabilities and stockholders' equity
\$328,605	\$304,871	

Source: 1978 Annual Report.



Exhibit 4

BROWN-FORMAN DISTILLERS CORPORATION

Product-Line Information

Share of Market	American Spirits (53% Brown Forman sales)	Industry	1977	% Sales Growth 1977	Sales Growth
NA	Jack Daniel's Tennessee Whiskey	NA	NA	NA	NA
3%	Old Forester Bottled in Bond Bourbon Whiskey	+4.4%	2.9%	2.9%	2.9%
NA	Old Forester Kentucky Straight Bourbon Whiskey	NA	2.0%	2.9%	2.9%
7.2%	Early Times Kentucky Straight Bourbon Whiskey	2.0%	2.0%	2.9%	2.9%
Imported Spirits (24% B-F sales)					
10.5%	Canadian Mist Canadian Whiskey	+11.5%	+3.1%	+0.2%	+3.1%
NA	Ambassador Scotch Whiskies	NA	+0.2%	+0.2%	+0.2%
NA	Usher's Green Stripe Scotch Whiskey	NA	NA	NA	NA
NA	Pepi Lopez Tequila	NA	NA	NA	NA
NA	Old Bushmills Irish Whiskey	NA	NA	NA	NA
NA	Martell Cognacs	NA	NA	NA	NA
Wines & Specialties (23% B-F sales)					
4.6%	Bolla Italian Wines	+32.5%	+37%	+37%	+37%
3.3%	Cella Italian Wines	+77%	+37%	+37%	+37%
NA	Cruse French Wines	NA	NA	NA	NA
NA	Veuve Clicquot French Champagnes	NA	NA	NA	NA
NA	Noilly Prat Vermouths	NA	NA	NA	NA
NA	Anheuser German Wines	NA	NA	NA	NA
3.2%	Korbel California Champagnes	11%	NA	NA	NA
6.1%	Korbel California Brandy	NA	+15.2%	+15.2%	+15.2%
NA	Bols Liqueurs and Brandy	NA	+9.0%	+9.0%	+9.0%

¹5-year percentage increase, 1971-76.

Sources: Company estimates and *Liquor Handbook* (New York: Gavin-Johnson Associates, 1982), 74.

Source: *Liquor Handbook*, 44 and 74.

BROWN-FORMAN DISTILLERS CORPORATION
Exhibit 5
Consumption Changes by Types of Distilled Spirits

Case Shipments

Product type		Change	
		1966-71	1971-76
		%	%
Total distilled spirits		+22.2	+9.8
American whiskeys		-4.6	-21.9
Blends		-7.3	-29.2
Straights		+0.9	-14.7
Bonds		-29.1	-36.4
Other		-26.2	+106.7
Scotch		+54.5	+8.2
Canadian		+70.6	+31.5
Gin		+18.9	+4.3
Rum		+77.1	+43.2
Brandy		+41.3	+15.2
Cordials, liqueurs		+44.1	+45.5
Vodka		+51.6	+55.1
Prepared cocktails		+30.3	+116.5
Other		+328.9	+97.7

BROWN-FORMAN DISTILLERS CORPORATION

Southern Comfort Corporation and Subsidiary
Income Statement
(For the years ended December 31)

	1976	1977
Net sales	\$ 57,308,426	\$ 64,183,392
Cost of sales	40,909,265	45,814,353
Gross profit	16,399,161	18,369,039
Selling, administrative, and general expenses	9,446,120	10,193,517
Income from operations	6,953,041	8,175,522
Other income (expense):		
Royalties on Canadian sales	329,804	355,940
Interest	(186,210)	(62,283)
Rental property, net	(141,457)	111,329
Other, net	(5,237)	2,466
Income before income taxes	6,949,941	8,582,974
Provision for income taxes	3,453,400	4,211,512
Net income	3,496,541	4,371,462
Earnings per common share	\$ 59.67	\$ 79.95

Source: Annual reports.

Exhibit 7

BROWN-FORMAN DISTILLERS CORPORATION

Southern Comfort Corporation and Subsidiary
Consolidated Balance Sheets, December 31

Assets	1976	1977
Current Assets:		
Cash	\$ 750,108	\$ 1,341,190
Accounts receivable	12,305,064	12,118,758
Inventories	6,554,342	7,365,841
Prepaid expenses	59,218	35,952
Total current assets	19,668,732	20,861,741
Property, at cost:		
Less: Accumulated depreciation	4,933,708	5,556,624
Investment in rental property, less accumulated depreciation of \$171,996 and \$106,878	2,105,195	2,439,268
Total property, net	2,828,513	3,117,356
Display Silver, at cost	1,673,585	1,614,633
Total property, net	4,502,098	4,731,989
Less: Accumulated depreciation	152,297	152,297
Display Silver, at cost	\$ 24,323,127	\$ 25,746,027
Liabilities and Stockholders' Equity		
Current Liabilities		
Notes payable to bank, unsecured	\$ 2,350,000	\$ --
Current portion of long-term notes payable	858,461	62,067
Federal spirits and rectification taxes payable	4,933,465	7,096,549
Accounts payable and accrued expenses	1,489,093	1,076,973
Dividends payable	8,493	8,343
Income taxes	572,571	738,279
Total current liabilities	10,212,083	8,982,211
Long-Term Notes Payable, less current portion	1,297,894	35,827
Deferred Compensation Payable, less current portion	51,200	--
Stockholders' Equity:		
Preferred stock, no par redeemable at \$10, \$3,974 shares	169,870	166,870
Common stock, \$1 par, authorized 170,000 shares, issued 120,000 shares	120,000	120,000
Retained earnings	19,011,274	23,363,049
Less: treasury stock, at cost, 66,214 and 65,437 common shares	19,301,144	23,649,919
	6,539,194	6,921,930
	12,761,950	16,727,989
	\$ 24,323,127	\$ 25,746,027

Source: Annual reports.

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BROWN-FORMAN DISTILLERS CORPORATION

Exhibit 8

Historical Data: Case Shipments
of Southern Comfort Corporation

Calendar Years	U.S.					
	Domestic	Export	Canada	Total	20-year compound growth	5-year compound growth
1958	109,347	2,380	5,635	117,362		
1959	123,928	2,528	6,000	132,456		
1960	145,667	2,621	6,707	154,995		
1961	149,998	2,778	7,166	159,942		
1962	168,063	3,409	7,505	178,977		
1963	182,220	4,746	8,225	195,191		
1964	210,331	5,569	9,600	225,500		
1965	269,687	9,662	12,540	291,889		
1966	332,719	8,937	15,518	357,174		
1967	381,457	12,253	18,408	412,118		
1968	443,993	16,024	19,484	479,501		
1969	524,171	15,945	23,334	563,450		
1970	541,832	20,784	26,923	589,539		
1971	617,201	39,031	36,129	692,361		
1972	684,115	61,184	48,478	793,777		
1973	716,798	190,678	61,828	969,304		
1974	829,341	232,795	70,407	1,132,543		
1975	850,778	189,123	85,141	1,125,042		
1976	904,993	291,185	95,070	1,291,248		
1977	1,047,896	303,916	111,566	1,463,378		
	11.9%	27.44%	16%	13.45%		
	8.8%	37.8%	18.2%	13%		

Source: Southern Comfort Corporation records.

Exhibit 9
BROWN-FORMAN DISTILLERS CORPORATION
Assumptions Used in Southern Comfort Cash-Flow Forecast
(in dollars except for case volumes [in units] and expenses [in \$000])

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
<u>Profit per case</u>											
U.S. domestic											
Revenue	\$49.62	\$50.62	\$51.42	\$52.42	\$52.92	\$53.92	\$54.92	\$55.92	\$56.92	\$57.92	\$58.92
Cost of goods	33.52	34.10	34.75	35.41	36.14	36.93	37.78	38.70	39.70	40.77	41.93
Advertising	4.07	4.01	3.80	3.68	3.83	3.89	3.92	3.97	3.33	3.18	3.37
Selling											
Regular	.55	.58	.59	.60	.61	.62	.63	.63	.65	.67	.70
Transition	.71	.34	.15								
Export											
Revenue	19.21	20.32	21.50	22.55	23.21	23.80	25.16	26.15	27.15	28.15	29.15
Cost of goods	7.08 and increases at 8% annually thereafter.	1.38	1.37	1.37	1.37	1.36	1.37	1.37	1.37	1.37	1.37
Advertising	1.44	1.38	1.37	1.37	1.37	1.36	1.37	1.37	1.37	1.37	1.37
Brokerage	2.75	2.76	2.75	2.85	2.72	2.69	2.68	2.67	2.67	2.67	2.67
Selling exp.	.05	.05	.05	.06	.06	.06	.06	.06	.07	.07	.08
Canada											
Royalty	3.48	3.48	3.48	3.48	3.48	3.48	4.00	4.00	4.00	4.00	4.00
Concentrate											
profit	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55
<u>Case volumes (in thousands)</u>											
U.S.	1,140	1,225	1,315	1,410	1,510	1,615	1,725	1,835	1,923	1,984	2,015
Export	325	350	380	405	425	445	463	480	490	500	500
Canada	115	125	138	150	160	170	180	190	200	210	220
<u>Corporate level¹</u>											
G&A Expense	1,665	1,800	1,944	2,100	2,268	2,449	2,645	2,857	3,086	3,332	3,599
Transition	430	380	180								
Settlements	400	400	400	400							
Interest expense ²	113	122	132	142	154	166	179	194	209	226	244

¹For forecasting purposes, investment to maintain plant and equipment could be expected to be offset by depreciation expense, but there would be some additional investment in working capital as sales grew.

²On seasonal borrowings for working-capital financing. Analysts at Brown-Forman viewed this item as virtually an operating expense and considered including it in their forecast of free cash flows.

Source: Brown-Forman Distillers Corporation estimates.

Source: *ISL Daily Stock Price Record*, Standard & Poor's Corporation.

Please see the second page for additional questions that must be answered for this case.

The length of the written final examination case can vary greatly, but counting exhibits that are not counted for 15% of the grade for the course.

It is very important that you have a professional word as this is a document and footnote all sources of information used as part of your solution.

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and other cases should be used. Examinations should be clearly stated if not.

	Class A	Class B	S&P 500 Index
1/3/78	19.875	20.000	93.82
2/1/78	19.750	19.375	89.93
3/1/78	20.500	20.500	87.19
4/3/78	21.875	21.250	88.46
5/1/78	23.500	23.750	97.67
6/1/78	24.750	24.875	97.35
6/2/78	24.875	25.000	98.14
6/9/78	25.625	26.375	99.93
6/16/78	26.375	27.000	97.42
6/23/78	26.000	26.500	95.85
6/30/78	25.625	24.875	95.53

Brown Forman

Stock-Price Data

BROWN-FORMAN DISTILLERS CORPORATION

Exhibit 10