Silkbush Mountain Vineyards

Management Report

To: **All Limited Partners, Silkbush Holdings, LP**

Silkbush Mountain Vineyards

Re: **Management Report**

Date: **August 17, 2018**

Silkbush Management Report

With the concurrence of the Advisory Committee (Ad Comm), Burdell Management Ltd., (BML), the General Partner, and Anton Roos, Silkbush Managing Director (MD) (collectively, Management), I, Dave Jefferson, am sending this to you to explain the facts and conditions facing Silkbush that directly impact you.

I will share with you decisions Management has made associated with their own beneficial interests in Silkbush and, ideally, provide you with information that will assist you to determine what is best for each of you, individually. Shortly thereafter, you will be offered the opportunity to select the course of action you intend to take regarding your beneficial interests in Silkbush. Let us start with a discussion concerning the impact of political, environmental, and market conditions impacting Silkbush and our mutual investment therein.

1. **Silkbush Investment Outlook.** While early winter Cape rains suggest (at least heading into the next harvest season) that the drought for the Western Cape may be over, the world-wide publicity that Cape Town could have run out of water this past April is strong discouragement for most potential ag investors. Coupled with further announced plans by the ANC government to confiscate property, especially farms, without compensation is quite depressing for existing and potential investors. And for us, the "last straw," was the recent **NY Times** lead story about how certain elements of the ANC government under the former President Jacob Zuma were effectively looting the RSA equivalent of the US IRS! This is virtually the Perfect Storm many feared 24 years ago, when the ANC took control of the national government, but it did not come to pass under the encouraging stewardship of Nelson Mandela and the benign administration of Thabo Mbecki. The following link is to a well-documented and damning discussion of the South African "Corruption Gutted South Africa's Tax Agency." It is very disturbing and further discouraging of any future investment by off shore investors.

https://www.nytimes.com/2018/06/10/world/africa/south-africa-corruption-taxes.html?emc=edit_th_180610&nl=todaysheadlines&nlid=535814400610

It is clear that under Jacob Zuma, a catastrophic abuse of SARS, the RSA equivalent of the US IRS, has taken place. And it is now appearing that looting of other large South African entities has been going on for years; the following article accuses McKinsey & Company, "the godfather of management consulting," of being tacitly complicit in financial wrong doings. Consulting for government itself is not a sin, but when top management at Transnet and Eskom are awarding contracts to affiliates and the potential for major kickbacks is apparent, McKinsey did not walk away. So effectively (and unknowingly?) they were driving the getaway car while the bank was being held up.

https://www.nytimes.com/2018/06/26/world/africa/mckinsey-south-africa-eskom.html?dlbk=&emc=edit_dk_20180627&nl=dealbook&nlid=53581440_dk_20180627&te=1

We are both shocked and now anticipate more of these major scandals to be uncovered. (The Rand has continued to lose more value almost daily since the news broke; as of today, the exchange rate is R14.65/US$. A year ago, it was R11.5/Dollar!) We anticipate this will decrease most international investment interest in South Africa for years to come. At a minimum, it certainly provides no legitimate justification in trying to raise any more equity or debt for Silkbush; in our judgment, additional investment would mean throwing good money after bad, and an abrogation of our fiduciary responsibilities to potential investors. The following articles are examples of the discussions being held publicly in South African media.

THE TROJAN HORSE THAT WHEELED R600M OUT OF STATE-OWNED ENTITIES

https://www.dailymaverick.co.za/article/2018-08-16-the-trojan-horse-that-wheeled-r600m-out-of-state-owned-entities/?utm_medium=email&utm_campaign=First%20Thing%20Thursday%2016%20August%202018%20Spartan%2064&utm_content=First%20Thing%20Thursday%2016%20August%202018%20Spartan%2064+CID_fdd47eece0228f6df613a137fcecccc8&utm_source=TouchBasePro

LAND MEANS NOTHING IF YOU CANNOT OWN IT

https://www.dailymaverick.co.za/opinionista/2018-08-16-land-means-nothing-if-you-cannot-own-it/?tl_inbound=1&tl_groups[0]=80895&tl_period_type=3&utm_medium=email&utm_campaign=Afternoon%20Thing%20Thursday%2016%20August%202018%20VW%20Arteon%2062&utm_content=Afternoon%20Thing%20Thursday%2016%20August%202018%20VW%20Arteon%2062+CID_dab9327dc5747410eb0d1db3cbac899a&utm_source=TouchBasePro&utm_term=Land%20means%20nothing%20if%20you%20cannot%20own%20it

FUDGING, OBFUSCATION AND MISDIRECTION HOBBLE THE ROUTE TO THE NITTY-GRITTY OF EXPROPRIATION

https://www.dailymaverick.co.za/article/2018-08-17-fudging-obfuscation-and-misdirection-hobble-the-route-to-the-nitty-gritty-of-expropriation/?tl_inbound=1&tl_groups[0]=80895&tl_period_type=3&utm_medium=email&utm_campaign=Afternoon%20Thing%20TGIF%2017%20August%202018%20VW%20Arteon%2064&utm_content=Afternoon%20Thing%

[20TGIF%2017%20August%202018%20VW%20Arteon%2064+CID_7563d39eef4b4ba62b619d0158e08a1b&utm_source=TouchBasePro&utm_term=Fudging%20obfuscation%20and%20misdirection%20hobble%20the%20route%20to%20the%20nitty-gritty%20of%20expropriation]

As the appended documents show, starting with the May 2018 W. Basson appraisal, there is evidently no meaningful equity in our vineyard project. That does not mean there is no property value, but rather the appraised equity (R38,000,000 roughly $2,800,000) is, at most, equal to the outstanding debt. We had the appraisal done by a local ag property real estate broker, Wimpie Basson, who we have known for some 21 years. We could engage a second professional for a second opinion, but we do not presently see the reason for it; Wimpie Basson knows the wine grape market exceedingly well. While it is possible the drought conditions have lifted, the negative international publicity of Cape Town's near brush with running out of water in April was very widespread. Now, coupled with the news that the prior ANC ruling group has been looting the treasury for years and with the push by ANC top officials for "appropriation without compensation" (especially farm land), why would anyone want to invest new money in this beautiful but financially troubled country?

Despite this very negative backdrop, Eileses Capital, an American investment company, based in San Francisco, recently purchased a Stellenbosch winery (Warwick Estate), about a one-hour drive from Silkbush toward Cape Town, and another wine farm, Uitkyk, located virtually across the R44 highway from Warwick. Warwick was developed and owned by the Ratcliffe family for the past 50 years. They have been skillful marketers and undoubtedly profitable; our understanding is the two properties were purchased for about a combined R200 million, or (under US$14 million, at recent exchange rates). A higher estimate of $32 million has also been thrown out. The Ratcliffes have been our friends for over 20 years, and we have been in contact with the Eileses principals by phone and email. We will undoubtedly learn more about the transactions in the months to come, but at present we consider this to be a market aberration, albeit welcomed.

We have solicited Wimpie Basson's willingness to list Silkbush for sale for about $4 million (R58 million). (We have little reason to believe we can obtain such a sale price during 6-12 months in 2019 but we may at least draw a bona fide offer or two.) Wimpie's initial reaction to an offering well above his appraised value was not highly enthusiastic, and not unexpected. However, he will do his best to locate a buyer; if he is successful, he will charge a 5% real estate commission. Since our lenders will, in all likelihood, be required to acquire Silkbush in 2019 for the debt of $2.8 million plus accrued interest by then, there is no reason to offer it for a lower price that does not have at least some potential for a meaningful return of a portion of the invested equity to then Silkbush partners.

Anton is in the process of informing our grape purchasing wineries that we will soon offer the property for sale. It is very important we do not spook them, as those relationships are quite important. Further, Anton and I will meet with our local bank, Nedbank, when I visit in mid-September. It is essential that Silkbush Holdings be restructured before 2019, and that no one be surprised during this procedure.

To say that Anton and his family have mixed feelings is an understatement. They are understandably worried as to what will happen. Anton's sons have grown up on the farm, love it deeply, and the family has hoped to live there for decades to come. Anton's wife's parents own the adjacent farm and living close to them has been a joy. However, the Roos Family 15% interest in future profits is now worthless, as is Burdell Management's 12.5%, and our US importer, Heritage Link's 2.5%. Anton has been working diligently for the past 18 years to create something of lasting value for his family, and clearly with the present arrangement, this will not happen with Silkbush with the cumulative debts incurred. From a family business standpoint, were Anton offered an equivalent position/compensation with another wine farm with a meaningful equity ownership it would be difficult for him to turn it down.

And the same applies to the total equity of $2,400,000 invested in the project since year 2000, and now evidently worthless, baring a surprise offer well above appraised value. Very disappointing, especially considering Burdell's success with vineyards in Napa and Sonoma. Yes, those entities took many more years than originally expected to become profitable, and funding cost overruns of 80%-100% were incurred, all paid with equity, but we always achieved significant profitability. Unfortunately, even if all Silkbush debt were converted into equity, little more than break even operations can be expected for years to come. And a highly diluted ownership interest in Silkbush is little motivation for Anton and any of our future key employees.

2. **Management Decisions.** Given the existential issues facing Silkbush described above, certain decisions have been made by Management in an effort to ameliorate the dire straits faced by Silkbush and ultimately to ceases its operations if fortuitous circumstances do not occur.

Vineyard to be offered for sale. The Silkbush vineyard and its equipment will be offered for sale, with marketing commencing in January, but a sale, if any at all, occurring after the April 2019 harvest. The asking price will be $4 million (US) (or R58 million, at R14.5/US$). This is significantly (but not unreasonably) higher than a recent appraisal but well less than our total investment, including outstanding debt, of about $5.5 million.

Marketing term. If the property sells during 2019, the Partnership will pay off its debts and distribute any remaining cash in accordance with the existing Partnership Agreement and its then current partners. (We do not consider sale a high likelihood due to adverse market conditions in South Africa, but we also believe the contemplated marketing effort should be adequate to determine if there are any qualified and motivated buyers at values equal to or above appraised value.)

Alternative anticipated 2019 conveyance to lenders. If a buyer is not located by June 30, 2019 for a value above its present appraised value of about $2,800,000, the Partnership may convey common stock ownership to its lenders, chiefly the Wine Fund LLC, other Burdell affiliates and certain Silkbush partners. [With no perceived equity in Silkbush above their loan balances, the lenders may not grant an extension of the debts a further six months] The present total debt is approximately $2,800,000, and bears interest of 6% per annum other than advances by Burdell Properties which are presently interest free. If required, the conveyance to the lenders will be at a date recommended by the Silkbush independent CPAs, between July 2019 and January 2020, and the then Silkbush General Partner.

3. **Abandoning Partnership Interests Alternative for Partners.** The organizational documents of Silkbush have express prohibitions against transfers or other dispositions of both general partnership and limited partnership interests in the absence of approvals by the partners. *See Article XIV of the First Restated Limited Partnership Agreement of Silkbush Holdings, LP.* Subject to satisfaction of these requirements (as a practical matter such consent will be satisfied as the interests of Management, including the Ad Comm member/partners and its affiliates constitutes the required super-majority for approval) prior to the end of 2018, all members of Management and the General Partner intend to formally abandon their respective Partnership interests after electing a Silkbush replacement general partner. Let us be clear. When we say we have an intention to abandon our interests, we use the term "abandonment" in the strictest and most narrow of meanings. We are talking about abandonment of our interests to sever our interests in the partnership to gain distinct anticipated tax advantages. We have no intention of abandoning our allegiances to partners and will assist in their decisions as to what is best for them.

Each of you must decide if, likewise, it is prudent for you to abandon your partnership interests. Electing abandoning partners are anticipated to be able to expense in 2018 their capital accounts, which should result in income tax savings to most electing partners of 40%-to 45% under the new US federal and state tax regimes, especially in the highly taxed coastal states of CA, NY, CT, IL, and MA where most of our partners reside. Accordingly, a 2018 $100,000 ordinary loss may reduce state and federal taxes as much as $45,000. <u>This tax treatment, however, cannot be obtained in a year where a property is sold or otherwise conveyed</u>. Evidently partnership interests abandoned during such later periods will result in a long-term capital loss, which is far less attractive. [A couple can only deduct up to $3,000 of long term capital loss against other kinds of income, including personal salary and interest income; capital losses greater than $3,000 can be rolled forward to future tax years or used to shelter other realized capital gains.]

Our collective capital accounts total just over $2 million (US) as indicated on one of the attachments.

Management is contemplating abandonment upon advice of US tax counsel that reports to Dave Jefferson that formal 2018 abandonment will result in partner <u>ordinary losses</u> reported on the 2018 Silkbush Holdings federal tax return equal to individual capital accounts as of December 31, 2017 (said opinion and the partners' 2017 capital accounts are listed on attachments to this memorandum.) Most significantly, should any partner deciding to abandon wait until the following tax year, the opinion is that the resulting tax losses upon property conveyance will be deemed <u>long term capital losses</u> and individual partner deductibility limited to $3,000/year plus any reported long-term capital gains.

Management and tax counsel are concerned that if a decision were made by Silkbush in concert by all of the partners, such a decision may be construed by the Internal Revenue Service (IRS) that abandonment is a mere step or element in a plan of dissolution. Were this the case, it would likely result in ordinary losses being denied by the IRS and frustrate that which is sought to be accomplished by abandonment. Consequently, Management's intention to abandon was made individually by each of the members of the Management team. You will, likewise, have an opportunity to elect to abandon, but Management is not advising you to do so. Each partner should make his/her own decision individually based on his/her determination as to what is best for them and with counsel from their own tax advisors. Given the concern that the IRS consider Silkbush to be acting in concert as to abandonment decision-making, the tax opinion obtained is directed to Dave Jefferson only. Your own tax advisors should assist each of you to determine what is in your best interest rather than rely on what is perceived best by the Management team members or to rely without your own counsel upon the opinion.

<u>Disadvantages to abandonment.</u> There are certainly reasons why abandonment may not be in the best interest of individual partners. Once a partner abandons his interests, it will be gone forever for all practical purposes. Were there a *deus ex machina* event that positively impacts the Cape, it would be worthwhile to maintain rather than abandon partnership interests. Although one may not consider it likely, environmental conditions may improve. Good government could come to power with the rule of law effectively applied. The wine market may decidedly improve or events may occur elsewhere that could provide the Cape with competitive advantages. These or other events unknown could increase the value of the vineyard enabling Silkbush to affect a favorable sale returning at least some of the investor contributions or even justify continuance of vineyard operations.

There also could be partners who have capital gains that would effectively be positioned to fully use the capital losses and would not obtain significant advantages by having losses characterized as ordinary.

With partners abandoning interests, remaining interests will accrete. This would mean remaining partners could receive a return on their investment from a sale at less that the vineyard target price of $4 million (US).

There are certainly other reasons that may be evident to you or your tax advisors as to why abandonment is not appropriate for you. Moreover, we do not have a formal IRS private letter ruling. There is no absolute assurance that abandonment will entitle you to ordinary losses instead of a capital loss on your investments.

4. **Replacement General Partner**. Given the approval to the abandonment the Management partnership interests, the recommended replacement general partner will be Kees Holding LLC, a private company owned by Andrew Hilliard, a lifelong resident of Green Bay, Wisconsin. Mr. Hilliard is very experienced in the South African wine business; he was majority owner of Beau Joubert Estate Winery (Stellenbosch, West Cape) from 2005 to 2016, when he and his partners sold their winery, at a financial loss. Andrew Hilliard, however, has continued as an exporter of South African wine under the same business name with the local assistance of his former winemaker, Christian Kuun. www.beaujoubert.com (Over the years, Andrew and his wife, Renee, have made multiple trips to the Cape, lived many months on their farm, and continue to spend 2-3 months per year in the Cape. Because the family has been acquainted with Dave Jefferson since 2002, they have visited Silkbush upon occasion, met with Anton Roos, and this past year purchased 10 tons of Shiraz from Silkbush for making Port wine for their account.

More information about Andrew and preliminary contractual undertakings with his company are also attached.) We believe Andrew and his company will do a highly satisfactory job in the role of replacement GP. We will propose a LP amendment in Octobert 2018 replacing BML with Kees Holding LLC/Andy Hilliard as the new GP for Silkbush Holding, in conjunction with a contract with Hilliard and his wholly owned company as to its functions and undertakings both vis a vis the listed vineyard property and the prospective interactions with the Silkbush present lenders. For its services, Kees Holding LLC has been offered a 1% partnership interest in the restructured LP as both a general and limited partner in separate affiliated entities. With the abandonment of interests, the Kees interests will accrete, so both general and limited partnership interests must be exant to maintain partnership status requiring at least two partners, should all existing partners abandon. In return, BML will continue advancing sufficient cash to the Silkbush lenders to keep them from demanding immediate repayment of their loans, and extending their loans at least until June 30, 2019. Extension of the loans to until January 1, 2020 may be possible but is not presently assured and may be unlikely.

5. **Timing and Documentation.** Our present intention is to have a Silkbush amendment prepared by October 2018, and then to email the legal documents to all Silkbush partners likewise within such month. The documentation will include the form paperwork that Management intends to use to affect the abandonment of their interest. If you choose, such forms may be used by you for such purpose, but no representation is made by Management as to the efficacy of such documentation. Should you elect abandonment, you should rely upon your own advisor for the best methodology and documentation to accomplish such purpose.

Dave Jefferson will be in the Cape during September to confer further with Anton, our local attorney and CPAs, and the prospective real estate broker. Since a super majority of the Partnership has already approved this plan in concept, we presumably will be able to announce by mid-October the LP has been amended, the replacement GP has been elected, effective by December 15th, and all Ad Comm members have abandoned their majority interests as of Dec. 31st. The last two months of 2018, BML will concentrate on answering any remaining questions and getting the signed forms back from any other remaining partners who also wish to abandon interests in 2018. While “bailing out” is an individual decision, it is an irrevocable decision and we must have everything buttoned up by year’s end.

Your decision to abandon, if any, should be made by you before December 31, 2018. Abandonment and dissolution in the same year will preclude ordinary losses, so your abandonment must occur in 2018 and Silkbush operations must continue thereafter into 2019 or beyond in order for abandonment to be effective as an option to partners.

6. **Ruminations.** Management realizes that what it is offering you is a "Hobsen's Choice." We have not made these decisions cavalierly or with happy hearts. Rather, this is a sad acknowledgement of financial failure after 18 years of extended efforts by all concerned. Anton Roos built and manages an exceptional vineyard and all partners have enjoyed excellent Silkbush wine from its grapes. However, we had to acknowledge that any future financial efforts would be almost exclusively for the financial benefits of our Wine Fund lenders (most who will become reluctant Silkbush limited partners).

This abandonment option has been reviewed on behalf of Dave Jefferson by the accounting firm of Sol Schwartz & Associates, P.C., San Antonio, TX, that has been doing the Silkbush returns for over the past five years. They believe this proposal is a viable and legal tax option for Silkbush partners and the Management team concurs. You will now need to decide if it is right for you.

We gave serious consideration to proposing a sharing of any net sales proceeds earned in 2019 with abandoning partners, but our tax advisors nixed the concept in no uncertain terms. Anyone abandoning their partnership interests in 2018 must have no future economic interest in Silkbush. Partners sticking around into 2019 would share in net proceeds, if any, from a sale above appraised value but likely not qualify for ordinary loss treatment if a sale does not result in 2019 and the economic ownership is transferred to the present lenders.

It is important for partners to have their individual tax advisors review this information before making an abandonment decision. The tax partners with Sol Schwartz CPAs will be available to respond to individual questions that arise. Their contact information is included on the enclosed tax opinion memo.

If you want to refer to this document online, click on:

https://silkbush.com/investors-information/?preview_id=3461&preview_nonce=6ca74217b9&_thumbnail_id=-1&preview=true

Dave Jefferson

Managing Partner, Silkbush Holdings LP

Attachments:

1. ***Advisory Committee membership and capital accounts in Silkbush Holdings LP***
2. ***Silkbush capital accounts summary***
3. ***W. Basson appraisal of May 18, 2018***
4. ***Silkbush outstanding debt vs. vineyard appraised value***
5. ***Sol Schwartz tax opinion letter of August 13, 2018***
6. ***Prospective replacement General Partner***