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Wineries Special Report

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The six most important factors affecting winery profitability

Premium wineries face many risks

BY VIC MORRO

The premium wine industry, which barely existed until the early 1970s, is going through a revolution in the 1990s. This revolution is being brought about not only by the industry's rapid growth, but by the complex nature of the business. In fact, it's hard to imagine a small business more complex than a premium winery. A premium winery must deal with the risks of agriculture; a long production cycle; marketing in a crowded, competitive, and highly regulated distribution system; and financing an extraordinarily capital-intensive and complicated business.

Profit factors

In this environment, some wineries are profitable, while many others are not. The question is: Why?

Analysis shows that the most important factors influencing a winery's profitability are:

- Market segment
- Winery size
- Pricing
- Marketing strategy
- Marketing execution
- Brand maturity.

Market segment

The wine market operates very differently within its various price segments. Profitability depends on understanding these differences and adopting appropriate strategies within each segment for each of the profit factors mentioned.

In the lower price segments, wine is similar to many other consumer products with commodity-type characteristics of:

- High volume
- Broad distribution
- Mass merchandising and advertising
- Competitive pricing.

The higher price segments are based more on:

- Image
- Prestige
- High quality
- Exclusivity

• Brand loyalty.

Whereas the low end is power marketing with small margins, high volume, and value, the high end is based on costly finesse marketing, high margins, and low volume.

Winery size

Profitability characteristics vary considerably with winery size. While substantial economies of scale exist for marketing costs, production costs have limited economies of scale. As a result, there are some definite size plateaus.

A number of small wineries producing 3,000 to 5,000 cases are able to command high prices, sell a large percentage at retail, appeal to a small, discriminating group of customers, and avoid the costs of larger, more bureaucratic organizations.

Wineries in the 30,000 to 50,000 case range can generate sufficient revenue to justify separate production and sales departments. Economies of scale are possible in both departments at this level, and the winery is still small enough to be in the higher price segments.

At 75,000 to 150,000 cases, a winery can realize even larger economies of scale in marketing and have a more sophisticated organization as well. However, pricing must often be in the next lower segment, and there are no substantial production economies.

Above 150,000 cases, a winery must be able to compete with wineries that are generally over 500,000 cases. In this size range, being smaller can be a marketing disadvantage.

Wineries operating between these plateaus typically adopt the organizational philosophy of the next higher plateau. As a result, they incur some of the added costs without the benefit of greater revenues.

Pricing

The most important pricing consideration is profitability. It would seem obvious that a winery must price its products to be profitable, yet examples abound of wineries dying a slow death due to under-pricing their wine.

First, the price must be appropriate for the segment. Many brands are positioned to be in one segment but are priced in a lower segment. This is usually a fatal mistake. Often this is accomplished by using (or

abusing) discounts and pricing programs. It is fundamental that a winery's products, pricing, size, selling proposition, and distribution all be in sync with the segment.

Next, the price must be sufficient to cover all the costs of producing, aging, marketing, and financing the wine. This is often not possible during the brand development years, but care should be taken to ensure that a price is established *today* that will make profitability possible once the target sales volume is attained. Too often, the plan is to start low with "value" pricing and increase prices later, once the brand is established. Unfortunately, the brand becomes established at an unprofitable level — often in the wrong market segment. A price change may then require a change in placements and customers.

Marketing strategy

No wine should be sold without a clearly articulated marketing plan in place. The plan must deal with the following:

- What you are selling, what you think you are selling, and what your customers think they are buying.
- Where you are selling, by market.
- To whom you are selling in all three tiers (wholesalers; retailers, including wine shops, restaurants, etc.; and consumers).
- Who buys it; who sells it.
- How much you are selling and when — by product, by market, and possibly by outlet.
- Why you are doing each of the above, integrated into one cohesive, purposeful marketing plan.

Once you have a plan, *stick to it*. Then monitor the actual results compared to plan, and *act on any variations*.

Marketing execution

Marketing wine takes time, imagination, perseverance, and money. Because wine is not a major consumer product, and because it is highly regulated, marketing and distribution costs are high. These same factors contribute to the lack of market data and the inefficiency of effective communication with the market. As a result, profits go only to those who can be efficient and effective in an inefficient environment. To be effective, a winery must understand its customers in all

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three tiers and communicate with them. The winners are usually those who are closest to their customers.

Brand maturity

Wineries don't make money until they are established. Until then, their overhead costs and profitability are often terrible. Owning a winery takes more investment per sales dollar than just about any other business. The investment and expenses come first. Income comes later. Much later. This provides great incentive for wineries to become established. Generally, the signs that a winery is established are that production and sales are more or less in balance and products, pricing, and distribution are somewhat settled. Most of the costs related to market development and brand building have been incurred, and most management errors due to inexperience and experimentation are past.

Conclusion

In today's competitive market, it takes more than good wine to attain profitability. It takes paying close attention to the six factors affecting profitability outlined here.

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