



## Think Micro, Not Macro

by Christian Miller

While many wineries are worrying about macroeconomic indicators of the state of the economy, such as the stock market or consumer confidence, their real worries over the next two years will be found in the microeconomic world of distribution channels, pricing, and competition from other wineries.

The link between economic or stock market trends and overall wine sales is tenuous. Several studies by economists have found no statistically significant link between GNP or stock markets and wine consumption. Sales of California table wine have, in fact, increased through the last three recessions in the U.S. While the link between sales of luxury wines and the economy has not been thoroughly tested, sales of wines over \$185 a case (FOB winery) increased 32% last year while the economy was weakening and the stock market tumbling. Finally, any economic effect short of a major depression may be offset by the influences of demographics, cultural trends, and a huge undeveloped market. These are the factors that have boosted or hindered wine sales in the past.

The recent shocking events in New York and Washington, D.C. may have more effect on wine drinking culturally than economically, if they dramatically affect the national mood. This is particularly true for marginal consumers, for whom wine is a celebratory beverage.

And let's not forget that we are NOT in a recession as far as wine consumers are concerned. Overall consumption of table wine continues to rise as does the average hourly wage. Job losses have mainly impacted younger workers, who are much less likely to be wine consumers. In fact, through June 2001, employment of workers over 44 years old actually rose versus the previous year. The highest per capita consumption of wine is found between ages 40 and 60.

### THE SALES "FUNNEL"

There has been a tremendous increase in new wineries, brands, and labels over the past two years. The number of wineries marketing Zinfandel in the \$15-20 range has increased over 150%; the number of wineries selling \$20-30 Chardonnay has increased over 100%. The crudest sort of math tells us that if the number of labels grows faster than wine sales, there is less demand per label available.

In contrast, the world of distributors and corporate retail accounts has undergone a period of consolidation, with fewer and more powerful buyers. This has a particularly strong impact on mass-market wines, which depend on these more powerful buyers and distributors to absorb the kind of volume on which their brands depend. When many sellers are competing for fewer buyers, it is inevitable that prices will drop for those sellers, though it isn't clear whether such price decreases will be passed on to the consumer.

High-end wines are less affected by this funnel effect. They actually have more buyers than a few years ago; direct sales via internet and mail order are up, warehouse clubs have moved into the high-end, and there has been a renaissance in fine wine shops in many markets. Also, the number of high-end restaurants increased tremendously over the past few years as did wine sales and prices at such restaurants. However, fine wine producers are still facing a much more competitive situation for the consumer due to label proliferation. *continued on back page*



—Christian Miller

### Director of MKF Research

Mr. Miller leads the team of researchers conducting custom research studies and producing proprietary reports including *Grape Trends*, *Wine Trends* and the *International Report*. He is a founding member of the Wine Market Council's Research Committee, and a regular lecturer for the U.C. Davis O.I.V. summer course. Mr. Miller holds an M.B.A. from Cornell University.

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## Partner Comment

As we approach our twentieth year of serving the wine industry, I am reminded of the many individuals and families we have helped to realize their goals, whether it is to buy or start a vineyard or winery, grow and manage their business, or ultimately sell or pass the business to the next generation. Success (defined as achieving the outcome *you* want) is critically dependent upon identifying your goals and creating a plan to achieve them.

This quarter we discuss transition and the many planning opportunities created by restructuring either personally or economically. New tax law will create continuing challenges for planning success. The new economy provides additional challenges as 'value' is also being redefined.

MKF is committed to monitor, research and understand how these trends impact your opportunities for transition in the Wine Industry. We appreciate and value your questions and comments.

—Kathie O'Dowd

*As an MKF partner, Ms. O'Dowd specializes in financial assurance and business advisory services. She also develops and teaches financial and related training courses for wine industry professionals.*



# Is Now the Time to Sell?

by Mike Fisher

The tremendous success of the ultra-premium and luxury wine business in the past few years has had a profound effect on the value of wineries and vineyards. Wineries are selling at values based on multiples of earning rather than solely based on the underlying asset values, which has driven value in the past. After many years of converting large fortunes into small fortunes, the wine business is finally making many winery owners wealthy.

This trend has surely prompted many vintners to question, "Is now the time to sell?" While a number of factors influence this decision, what is certain is that there will be an exit from the business at some time. If contemplating a sale, a number of important factors should be considered:

### PERSONAL ISSUES

Is now the time to retire? Are there other opportunities to pursue? Is there more potential with another type of business or other investment opportunities? Are other family members involved in the winery; if so, how will a sale affect them? What will be the effect of the sale on income and estate tax planning? Are the sale proceeds needed or desired for personal or lifestyle reasons? Is now the time to move from building wealth to preserving wealth through diversification of net worth?

### INDUSTRY LIFE CYCLE

How long will we continue to see double-digit growth in the ultra-premium and luxury wine business? This segment of the wine industry has made strides in growing from a cottage industry in the 1980s and early 1990s to a more mature, professionally managed business of today. However, we still have a long way to go, not only in size but also in maturity. Will we ever revert back to the earlier years prior to 1980 when the California ultra-premium and luxury wine industry was barely considered a legitimate business? Or will we continue to develop into a highly profitable luxury goods business as seen with our European counterparts in Champagne or Bordeaux?

Strategic buyers of ultra-premium and luxury wineries have justified high valuations based on reduction of sales, marketing and administrative

costs. By waiting to sell your winery, will the economies of scale to potential purchasers be diminished? Will consumer trends and increased competition eliminate the ability to increase volume and price thereby reducing value?

Where are we on the valuation curve? Are we now peaking or will values continue to increase?

### THE ECONOMY

Where is the economy today and where are we headed tomorrow? In 2001, we have seen declining GDP growth and corporate profits, reduced consumer confidence, lower interest rates, and low inflation. How does this affect the demand for premium wine? How does this affect the availability and cost of capital needed by potential buyers? What about the psychological effect of a slowing economy on potential buyers?

### POOL OF BUYERS

Who are the potential buyers? Recent buyers have been expanding brands and capacity by making strategic purchases through streamlined operations and reduction of costs. How long will this group be in a buying mood?

Because of the premiums paid by these strategic buyers, few investment buyers (those purchasing a winery based solely on the investment return of the existing business) have shown interest lately. Lifestyle buyers have always shown interest, but generally limit their search to artistic successes.

### IS THE WINERY READY FOR SALE

Is the winery to the point of maximum profitability? What are the growth prospects and competition at the existing product mix and pricing? How well will the product mix fit with potential buyer's product lines? Is strong management in place and willing to remain after the sale? Is the distribution network developed and operating efficiently? Are grape sources secure? Is historical and projected financial, management, and operating information accurate and readily available? Has the winery developed an effective strategic plan and is the

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# Tax Implication of a Sale

by Amy Smith

Recently, a number of wineries have sold at nearly three times the fair market value of their net assets. Several tax planning opportunities are available to winery owners that can reduce, defer, or exclude some of the income tax impact of the winery sale, and reduce subsequent estate tax exposure. The key is how the sale is structured for the specific entity type and the structure of the winery owner's estate tax plan. This article addresses some of the many income and estate tax-planning opportunities available to winery owners who are interested in selling their wineries.

## C CORPORATIONS

Non-corporate stockholders of C corporation wineries can exclude 50 percent of the capital gain from the sale or exchange of *qualified small business stock* issued after August 10, 1993 and held longer than five years. There are certain restrictions to this type of exclusion; if applicable, it can substantially reduce the tax impact of the sale of their stock. Another popular sales structure for a C corporation winery is a tax-free exchange in reorganization. No gain or loss is recognized if the winery stock is exchanged solely for stock or securities in another corporation that is a party to the reorganization. The winery owner defers the gain recognition and tax impact until he sells the stock received from the reorganization.

## FLOW THROUGH ENTITIES

Individual owners of flow through entity wineries, such as partnerships, LLCs, and S corporations, can save up to 19.1% in federal taxes when the winery sells its assets with the appropriate asset allocation agreement. The gain recognized from the sale of the winery's assets is characterized as either ordinary or capital. The gain characterization is based on the winery's sales contract asset allocation agreement. The asset allocation agreement allocates the selling price among ordinary income and capital gain type assets. Gain recognized on the inventory, fixed asset depreciation recapture, and a "covenant not to compete" is characterized as ordinary income and is taxed up to the current maximum federal individual rate of 39.1%. Gain recognized on the fixed assets, in ex-

cess of the depreciation recapture, and on goodwill, is characterized as capital and taxed at a reduced maximum federal tax rate of 20%.

## ESTATES

Winery owners interested in passing ownership to their children can take advantage of gifting an interest in their winery to the children, reducing the parent's taxable estate. The fair market value of the gift can receive a 20% to 40% minority interest discount and lack of marketability discount. Down the road, if the winery is sold, appreciation of the gifted interest is excluded from the parent's estate. Gift tax can be avoided by making use of the current \$10,000 per donee annual gift exclusion and the current \$675,000 lifetime estate exemption.

If you are considering selling your winery at any time, we recommend that you schedule an appointment with one of our consultants who specializes in income and estate tax planning and family business succession planning.

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### Ways to Pass Ownership of a Winery:

- Sell Stock
- Sell Assets
- Exchange or Reorganization
- Gift



### —Amy Smith, CPA

Ms. Smith specializes in income and estate taxation. She provides tax planning, advisory and compliance services specific to the wine industry. Ms. Smith has a Master of Science in Taxation.

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plan being followed?

All of these attributes have a major effect on value and determine whether the winery is valued as a business or just a group of assets.

## SUMMARY

This brief overview is not intended to cover all issues related to the decision of when to sell. It is offered as food for thought. However, if you are considering the sale of your winery, MKF can help evaluate your strategic options and assist in implementation.



### —Mike Fisher

#### Partner & Business Consultant

Mr. Fisher is extensively involved in wine industry business consulting. He has prepared over one hundred winery and vineyard valuations and has testified as an expert witness in a number of litigation cases involving the wine industry. He has degrees in accounting from the University of Missouri and enology from the University of California, Davis.

# MKF in the news: Excerpt from winebusiness.com, "MKF mid-year report"

Despite signs that the U.S. economy is weakening, Christian Miller, research director with industry consulting firm Motto Kryla Fisher, does not expect the economy to drive a decline in wine sales.

"The basic trends that have been in place for a year or two are continuing, but the results, winery to winery, are much more diverse," Miller said this week. "The high end is still growing, the low end is struggling, and for everyone, competition is a lot stronger."

Having conducted a mid-year assessment of the U.S. wine market, MKF is saving the gory details for its clients, but some of the key findings follow:

- Sales of medium- and high-priced wine continue to grow in 2001 but not at the high rates of 2000,

and low-priced wines continue to struggle in 2001.

- Sales of "fighting varieties" (retailing for \$3 to \$6 a bottle) now appear to be declining at the same rate as jugs and generics.

- Among the 34 small and medium wineries surveyed, year-to-date total case sales rose by 13 percent while revenue was up 17 percent.

- Grocery store scan data: Sales of wines selling for more than \$5.50 are up, while sales of wines selling for less than \$5.50 are down.

"The tide is still rising, but some of the boats are springing leaks," Miller said. "The strong wineries are going to become even stronger."

*Please see entire article on [www.mkf.com](http://www.mkf.com).*

## Think Micro, Not Macro (continued from front)

### MICROECONOMIES

Just as with microclimates in viticulture, there are microeconomies in wine marketing to which one must pay attention. Over-dependence on certain channels of distribution may make life difficult in the near future.

The current economic difficulties are most severe in the stock market and certain troubled industries. Presumably, expense account restaurants in the areas most affected will be impacted heavily, reducing their demand for wine. Speaking generally, the last recession had a greater effect in the on-premise sector. Retail wine sales continued to rise during that period.

The current troubles also affect certain regions much more severely. Wineries with a strong

on-premise presence or concentration of mailing list customers in San Francisco and Silicon Valley may feel the pinch too. Chain grocery sales in California are much weaker than other states this year.

The ability to get sales support from certain key accounts, be they fine wine retailers or restaurants, will depend on the level of competition both within and outside one's distributor and the proper matching of price, image and positioning to the key accounts.

In sum, we at MKF Research remain optimistic on the overall market for wine in 2001, and fine wine in particular. But for individual wineries, the "do-no-wrong" market of the late 1990s is over. Wineries will need to keep a close eye on their distribution strategy, the supply and competition for their particular niche, and the sales trends in their price segment.



MKF is the leading firm of wine business advisors, providing business consulting, industry research, and CPA services to the owners and managers of over 200 wineries and thousands of vineyard acres. MKF serves the premium wine industry exclusively.

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## WINERY SALARY SURVEY COMPLETE

The seventh biannual Salary Survey of California Wineries, a collaborative effort between MKF and *Practical Winery and Vineyard*, has just been completed. This survey covers the 2000 and 2001 compensation and benefits earned by California wine industry employees based on data that was collected in June of 2001.

Survey results indicate that California wine industry compensation and benefits continued to increase from 2000 to 2001 at an average of 3%-16%, depending on the surveyed position.

Look for the survey in the November/December issue of *Practical Winery and Vineyard* or at [www.mkf.com](http://www.mkf.com) after November 1, 2001.