



## Under Construction...?

By Wendy Petersen, CPA

If you are building or considering building a new winery, would you be interested in depreciating some costs of the construction in your tax return at a rate faster than 39 years? Of course you would!

"But which costs qualify?" you might ask. The answer, according to the IRS, is those costs that are not "an inherently permanent structural component." Qualifying seems to depend more on its use, rather than permanency. A recent court case helps us define assets that qualify for faster depreciation.

### Examples of assets that qualify *may* include:

- Air conditioning, cooling, or heating systems installed for wine production
- Electrical and plumbing specific to production equipment
- Carpeting, vinyl flooring, and wall coverings
- Movable and removable partitions
- Crush or tank pads (so long as they are not a structural component of the building)
- Raised floors (non-structural) installed over an existing floor, to accommodate wiring, ducts, etc.

### Not allowed are:

- Air conditioning, cooling, or heating systems for comfort and convenience
- Electrical and plumbing relating to building operation and maintenance
- The structure - walls, floors, roof, ceilings
- Fire protection system
- Bathroom fixtures
- Lighting fixtures used for primary source of lighting

We say "assets that qualify may include..." above because the rules are subject to interpretation based on the facts and circumstances of each case.

Here is an example:

Asset	Cost	Tax Life	Annual Depreciation*
<b>Without Component Breakout</b>			
Building	\$ 3,000,000	39 Years	\$ 76,923
<b>With Component Breakout</b>			
Building	\$ 2,200,000	39 Years	\$ 56,410
Equipment	\$ 800,000	7 Years	\$ 114,286
	<u>\$ 3,000,000</u>		<u>\$ 170,696</u>
<b>Additional Depreciation Expense</b>			<b>\$ 93,773</b>

The key is to analyze your plans *before* construction begins. We can help you identify components that can be split from the structural pieces. Additionally, we can coordinate with your contractor to provide guidance on how to separately state the costs for the various components, rather than group everything together in their invoices.

Planning and preparing in advance provides the documentation necessary to substantiate the cost allocation for the construction project. Trying to construct these separate components *after* the fact becomes not only difficult and aggravating, but may not be honored if questioned by the IRS.

\*Note: Actual depreciation expense will vary depending on the asset type, method used, and the year. Inventory capitalization rules still apply.



—Wendy Petersen,  
CPA, MS Tax

Ms. Petersen specializes in income taxation. She provides tax planning, advisory and compliance services specific to the wine industry.

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Today the California wine industry is at a major turning point. Many things will change as a result, driven by the globalization of the wine industry and consolidation in all three tiers. Changes include:

- More International investment in and opportunities for wineries
- An expanded global market for wine
- New categories of wine emerging to serve the global market
- New consumers for wine with spreading affluence and more global consensus on tastes
- Higher quality standards for wine, encouraging consumers to continue trading up

We're seeing a continuous cycle of replacing old, less efficient methods and products with new, more efficient ones that fit current tastes. Rapid communication speeds up this process. Winery executives are using professional methods to succeed in the changing environment including:

**Strategic planning** – making a more careful choice of direction based on trends and measurable opportunities

**Performance Benchmarking** – using financial, sales and market information to evaluate and improve performance

In our 20th year, MKF is developing many new tools for wineries to respond to these changes.

### —Vic Motto

*MKF founding Partner and Consultant. Director and/or advisor to several wine industry trade groups. Mr. Motto is an author and speaker on wine industry issues and is frequently quoted as a wine industry expert and economist.*



# Winery Performance Evaluation: A Hypothetical Case Study

By Karen Coleman, CPA

Mystery Winery, a mid-sized North Coast winery, currently sells 60,000 cases of primarily Merlot and Syrah. In 2001, its average revenue per case was \$150. A brief summary of its annual growth from 2000 and its actual-to-budget performance in 2001 is shown below.

## MYSTERY WINERY PERFORMANCE

	% Growth	Actual	Budget
Wine Sales (\$000)	9%	\$9,000	\$8,600
Gross Margin (\$000)	10%	\$4,600	\$4,350
Operating Income (\$000)	14%	\$2,075	\$1,875
Cases sold	5%	60,000	59,000
Average revenue per case	3%	\$150	\$148
Gross margin, % of sales	1%	51%	51%
Operating income, % of sales	5%	23%	22%

Based upon the actual 2001 results, how well did Mystery Winery perform? Did management do a good job? Did its distributors do a good job?

## COMPETITOR PERFORMANCE

Now consider the following information about the performance of a sample of similar sized wineries (ranging in sales volume from 45,000 to 85,000 cases) in 2001.

	Mystery Actual	Peer Composite
Average revenue per case	\$150	\$170
Pricing growth	3%	4%
Volume growth	5%	6%
Gross margin, % of sales	51%	58%
Operating income, % of sales	23%	27%

Does this additional information change your evaluation of Mystery Winery's performance?

## MARKET PERFORMANCE

Further consider the following information about total 2001 domestic sales of California Merlot and Syrah.

	Merlot	Syrah
Revenue growth	8%	>100%
Volume growth	7%	>100%

How does this information affect your evaluation of Mystery Winery's performance in 2001? Does it change your assessment of distributor performance? Management performance?

## SUMMARY

As you can see from the above case study, evaluating performance is not necessarily straightforward. What appears to be strong performance at first glance can often seem less so (and sometimes more so) relative to the performance of your peers or of the market overall.

Good performance may not be sufficient if your peers are doing better, and you are losing share within your market segment. In order to increase the likelihood of long-term success, it is critically important to assess your winery's performance (as well as its strengths and weaknesses) in relation to your competitors and the industry overall. If you are not considering the relative performance of your peers and the markets in which you operate, you are at a disadvantage and leaving more to chance. To stack the odds in your favor, make sure you are counting *all* of the cards, not just your own.



—Karen Coleman,  
CPA, ABV, CVA, MBA

*Ms. Coleman specializes in business valuation and consulting services. A member of several wine industry organizations, she is a regular participant and speaker at industry seminars, conferences and courses.*



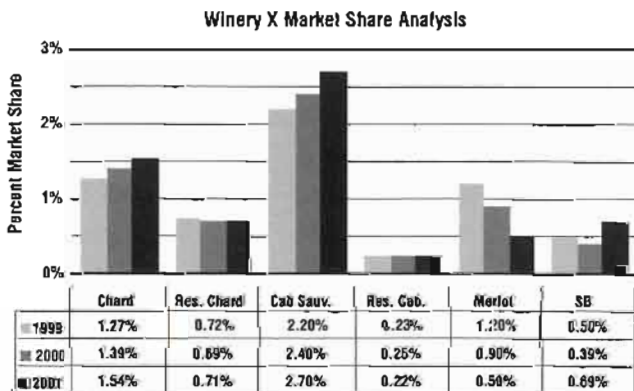
# A Two-Sided Tale

By Michelle Rowell

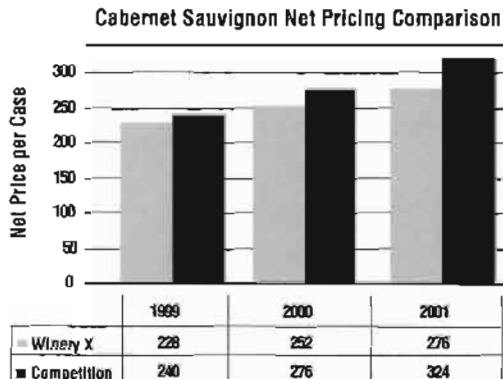
"It was the best of times, it was the worst of times..." wrote Charles Dickens in *A Tale of Two Cities*. Such a dichotomy can easily be applied to the recent history of the wine industry.

While researching our recently published *Wine Trends 2002 Report*, the exceedingly variable results of wineries over the course of the last year became evident. Overall market trends were positive, and although some wineries experienced significant growth, others found themselves lagging behind not only the total market, but their direct competitors as well. Wineries which performed differently from the market sought to discover the reasons behind their divergent results by asking us to evaluate their performance over the past few years.

This type of evaluation allowed us to identify the areas in which these wineries were strong as well as those which needed the most critical attention. MKF conducts this assessment, which we call a Market Performance Analysis, by comparing a winery's performance against a varietal and price segment, or against a smaller set of direct competitors. Each wine is analyzed separately, and its volume and revenue growth, market share, and pricing is benchmarked using data on varietal trends and price category behavior.



A winery with the above hypothetical results could easily spot the strong increase in its Cabernet market share. With that knowledge in mind, take a look at the next chart:



During the same period it met with strong demand and increased market share, Winery X's Cabernet was consistently priced far below its competition. Winery X seems to have missed out on an excellent opportunity to increase its profit margin. Further analysis would allow us to determine the optimal price for this wine, as well as if a price increase would affect volume.

The above example charts are from "the best of times." Many wineries aren't faced with such nice problems lately, indicating an even more critical need for such a practical planning tool.

In addition to price changes, some of our clients have used a Market Performance Analysis to reduce the number of wines and varietals offered, refocusing their efforts on what's working and getting rid of the non-performers in flat market segments. For other wineries, we identified states with below average market share, causing them to revisit their allocations. Our Analysis is a useful tool for business reviews, allowing you to compare your wholesaler's performance against trend data, eliminating the possibility of blaming underachievement on the market. Additionally, sales managers use our Analysis as a statistical basis for forecasting sales growth, which they can then share with their sales force as a justification for increasing goals.

Dickens' quote continues, "It was the age of wisdom, it was the age of foolishness..." Which of these describes your winery, depends on the strategic decisions you make every day, and the depth of information you use to make them.



—Michelle Rowell

As a Senior Market Consultant, Ms. Rowell helps winery executives with market, sales and channel planning including product pricing and channel performance assessments.



# MKF in the News:

**Pinot Pride:** Excerpts from *Harpers, The Wine & Spirit Weekly*, by Larry Walker

California's winemakers are out to challenge France's finest Burgundies with their Pinot Noir. This year, Mondavi released six different Pinots. Mondavi's Napa Valley bottling and the Napa Reserve are made almost entirely from Carneros fruit, which is one of three California regions that have a handle on Pinot Noir.

The others are in Santa Barbara on the Central Coast, and the Russian River Valley in Sonoma. There are a few other Pinot Noir outposts on the Central Coast—Chalone in Monterey and Calera in San Benito County. There is also a lot of interest in the very cool Anderson Valley area of Mendocino County, where Navarro Vineyards has made outstanding Pinot Noir for years.

The great improvement in California Pinot Noir has come about for the obvious reasons—proper site selection (witness the number of single-vineyard Pinots being made); more diverse and better clonal selection; and better treatment in the winery.

In Carneros, Acacia and Sainsbury were among the Pinot Noir pioneers. According to research by MKF, the Napa-based wine business consultants, the most expensive Pinot Noir grapes in California now are grown in Sonoma County, most of them in the Russian River AVA. The average price per ton for Sonoma Pinot Noir in 2001 was \$2,213, \$76 more than Napa, where most Carneros Pinot is grown.

Mike Fisher, a partner in the firm, noted that there seemed to be a major shift among wineries from

buying Carneros fruit to buying Sonoma fruit from Russian River.

If one starts making a list of the top California Pinot Noir producers, it becomes apparent that it is dominated by Russian River wineries. Just a short list would include (in no particular order): Davis Bynum, Rochioli, Dehlinger, Gary Farrell, Marimar Torres Estate, Merry Edwards, Iron Horse...

The market has responded very well to the improvement in California's Pinot Noir. Fisher of MKF divides Pinot Noir into three main price categories. "Pinot Noir growth is clearly at the high end. In 2001, almost 50% of all Pinot Noir sold for over \$15 a bottle." The volume total over \$15 for 2001 was one million cases, compared to 700,000 in 1998. Across all three price categories, there were 2.1 million cases of Pinot Noir sold in 2001, with 500,000 cases in the \$8-\$15 category. In comparison, sales of Cabernet were 15 million cases and Merlot 17 million. However Fisher does throw up a warning flag. "I see a doubling of Pinot Noir plantings in the next three to four years, with most of that in Sonoma County."

"Pinot Noir is very site specific and it could be that not all of those plantings will make good wine, or at least the kind of wine that sells for \$15 a bottle," he says. But one result of that could be more growth in modestly priced Pinot, since if the grapes aren't good enough for the \$15 cut, they might attract consumers at \$10 or under (a price range that currently contains very few Pinot Noirs).



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

For more information, please call Lisa Anthony, Director of Marketing: 707-967-5322 or e-mail [lanthony@mkf.com](mailto:lanthony@mkf.com)

## WHAT'S NEW IN THE WORLD OF PINOT NOIR?

According to the *Wine Trends Varietal Report 2002 - Pinot Noir*, the oversupply of Pinot Noir grapes will likely result in price changes in the next few years. Top quality vineyards in prestigious appellations will continue to receive high prices for their grapes. Vineyards in other locations, without preferred clones, terroir, or viticultural practices will see demand fall and prices drop for their grapes. We will probably see wineries expanding their Pinot Noir programs and/or introducing second labels, particularly in the \$10-20/bottle segment. Expect significant increased competition in this category!

To find out more about ordering the *Wine Trends Varietal Report 2002 - Pinot Noir*, please contact Lisa Anthony at (707) 967-5322 or email at [lanthony@mkf.com](mailto:lanthony@mkf.com)



MOTTO KRYLA FISHER LLP

Wine Business Advisors

The Wine Business Center  
899 Adams Street, Suite E  
St. Helena, CA 94574

707.963.9222  
707.963.1379 Fax  
[www.mkf.com](http://www.mkf.com)