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MKF

WINE INDUSTRY

BUSINESS UPDATE

GRAPE PRICES-
Where do we go from here?

Mike Fisher

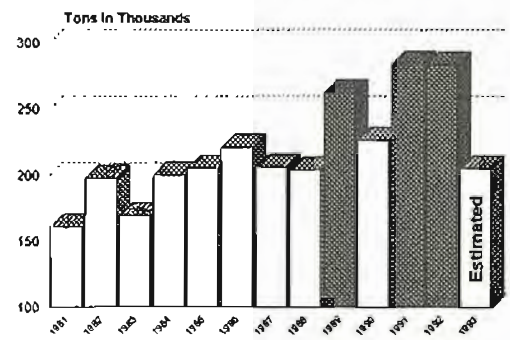
This harvest we heard reports of North Coast growers unable to sell their grapes at prices anywhere close to last year's. Of course, the most visible prices were those received on the spot market, which represents only 10% to 20% of the total grape market. Because of lower tonnage (estimated to be 20% to 30% below 1992), demand did firm up at harvest, with almost all grapes being sold. But even with the lower supply, reports of $800 to $900 per ton for North Coast Chardonnay were heard. In spite of the drop in tonnage there is still an oversupply of some varieties in the North Coast.

This oversupply seems contrary to what would be expected based on the double-digit growth of premium wines for the last few years. One explanation may be the plateau effect of the tonnage for Napa and Sonoma counties over the last few years. For the period of 1981 through 1983, tonnage averaged in the range of 175,000 tons. For 1984 through 1988 the average tonnage increased to slightly more than 200,000 tons. But beginning in 1989 tonnage increased substantially and has continued at a much higher average level (265,000 tons) through 1992. The vintage of 1990 was the only light year of the four vintages (but still above the highest year prior to 1989 at 226,000 tons). This increased tonnage occurred without major increase in acreage. The graph depicts this trend.

The big question is whether these large crops for three of the last five years (if 1993 is included) constitute a trend or a cyclical aberration. The drop in tonnage projected for the mid-to-late 1990s due to phylloxera replanting will also have an impact. Historically the grape market has been cyclical, even with level crops and no major replantings. Consequently, we may see more severe grape shortages than we have experienced during other cyclical swings.

Grape Tonnage

NAPA AND SONOMA COUNTIES



Basic supply and demand economics tells us that if supply is reduced without a drop in demand, prices will increase. But looking at this a little closer, grape prices won't go up if the economics of higher grape prices don't work for the wineries, i.e. demand drops dramatically as prices increase.

Because of the polarization of the premium wine business, the grape market is becoming two-tiered. The majority of grapes fall into the lower tier and are purchased by larger wineries producing wines sold for a retail price of less than $10 per bottle. These grapes are viewed primarily as a commodity. The upper tier consists of speciality grapes which have specific attributes, allowing higher wine prices, for which the winery pays a premium.

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Prices paid for commodity grapes are a function of the consumer price of the wine made from those grapes. To illustrate, we'll use a hypothetical 500,000 case-per-year winery. This winery sells its wine for an FOB price of $57 per case, which equates to a full retail price of $9.50 per bottle, based on standard mark-up in the three-tier system. (Of course, you'll be able to purchase it for $7.99 at Safeway on special.)

In three different scenarios the winery pays $900, $1,200 and $1,500 per ton for the grapes. This winery produces a high quality wine using coastal grapes and French oak barrels. The wine is labeled California appellation because of the desired flexibility of using both central and north coast grapes. Central Valley grapes are not used as "filler" to reduce the cost because of quality considerations.

Grape Price/Ton	$ 900	$1,200	$1,500
Production Cost/Case-			
Grapes	$15	$20	$25
Barrels	6	6	6
Other Processing	5	5	5
Bottling	8	8	8
Production Cost/Case	34	39	44
Per Case -			
Revenue	57	57	57
Production Costs	(34)	(39)	(44)
Gross Profit	23	18	13
Marketing	(10)	(10)	(10)
Administration	(3)	(3)	(3)
Profit Before Tax	10	5	0
Income Tax	4	2	0
Net Profit	6	3	0
Cases Sold	500,000	500,000	500,000
Net Profit	$3 million	$1.5 million	$ -0-
Investment in Assets	$30 million	$30 million	$30 million
Return on Investment	10%	5%	0%

The bottom line, literally, is that the economics work at $900 per ton, but as grape prices increase the net profit decreases rapidly. Wines sold at these prices leave low margins, with grapes being a major component of costs. Those who succeed do it with volume.

On the other hand, the winery may be willing to pay substantially more than commodity price for speciality grapes. Speciality grapes have one or more of the following attributes, which are important to a winery:

- ***Appellation or vineyard designation***

  This is basically a labeling consideration but can be extremely important to a winery's marketing program or message. How important it is and the availability of substitute grapes determines how much more of a premium the winery will pay.

- ***Unique characteristics related to a specific vineyard location***

  What the French call *terroir*, this is a function of both the soils and micro-climate. If grapes from this vineyard produce a wine with distinct characteristics the winery will pay more.

- ***Vineyard development techniques and farming practices***

  As technology advances, the grower has more and more influence on the quality and characteristics of the fruit. Spacing, canopy management, yield, organic farming and many other controllable factors influence quality.

- ***Variety and clonal selection***

  Matching variety and *terroir* are becoming more important as the California premium wine industry matures. Wineries continue to expect more from growers. Growing Sauvignon Blanc on Mt. Veeder may not make sense. Also having the "hot" variety will help in receiving high prices until supply and demand for that variety stabilize. There weren't many growers of Sangiovese or Merlot who failed to sell their grapes at good prices in 1993.

- ***Consistency***

  Grapes that make up an important component of a winery's successful blend consistently from year to year are critical to the success of most ultra-premium wines. This consistency is a function of grape source and if a vineyard is an important component, even though the grapes are not distinctive by themselves, the grower can expect higher prices.

Of course every grower feels that his or her grapes are specialty grapes, but because of continued polarization there will be fewer and fewer tons which command specialty prices. As wineries are fully aware in marketing of their wines, those who distinguish themselves receive speciality prices.

YEAR END TAX PLANNING

Susan Winer

At this time of year everyone wants to know, "What can I do to lower my taxes? Should I prepay my state taxes? " and "How much will I owe in April?"

The time-honored strategy of postponing income and accelerating deductions to defer taxes until the following year is no longer a complete answer under today's incredibly complex tax law. The relationships between adjusted gross income and the allowability of deductions, as well as the relationship between the regular tax laws and alternative minimum tax laws, require a complete review of not only the 1993 tax situation, but projections of 1994 income as well.

For example, prepaying your state taxes can, in some circumstances, increase your itemized deductions, thereby reducing your Federal tax burden in 1993. It could, however, subject you to alternative minimum tax. Furthermore, if your itemized deductions will be limited due to your adjusted gross income in 1993, the benefit may be better utilized in the following year, depending on your projected income for 1994.

As you can see, no answer is a simple one, but certain strategies should be considered. As a vineyard owner, you may have the ability to shift net income from one year to another. Renegotiating grape contracts with wineries could allow you to either accelerate or delay receipt of grape payments. Payment by credit card before year-end by a cash basis taxpayer is considered an expense even though the credit card bill will not be paid until the following year. Purchasing new equipment in 1993 can take advantage of the election to expense rather than depreciate such equipment if you meet the requirements. Vintners, however, will want to consider postponing equipment purchases until 1994 in order to take advantage of the investment tax credit, which will offset California tax.

Retirement planning can also be an effective way to both reduce your taxable income and plan for the future. Various retirement plans can be utilized by winery and vineyard owners, including employer pension or profit-sharing plans, 401(k) plans, Keogh plans, simplified employee pension plans, or IRAs. These plans are subject to a myriad of rules, of course, but can be used to effectively defer tax in the right situations.

Shifting income to your children can reduce your overall tax burden as well. One way to do this is by employing the kids to work in your vineyard or winery during the holiday season. Earnings by children under the age of 18 who are employed in a parent's business (but not corporations owned by the parent) are not subject to self-employment tax. Furthermore, the child can offset up to $3,700 of earned income with the standard deduction so no tax is due by the child.

"Vintners will want to consider postponing equipment purchases until 1994 in order to take advantage of the investment tax credit"

The above ideas (and many others) must be examined in conjunction with accurate projections of taxable income for 1993 and 1994. If your tax liability is higher this year due to the new laws, you may be able to pay the increased amount over a three-year period. This is not the case, however, if you are subject to the alternative minimum tax. At the same time, changes in the alternative minimum tax rules will, unfortunately, subject more taxpayers to the AMT tax than ever before. Thus, you can see, timely planning can be critical.

Planning for April 15th and beyond is best considered before December 31st to provide the maximum amount of flexibility.

CLASSIFYING WINE PRODUCTION AS VALUE-ADDED

Kathryn Ausen

A wine's character is composed of flavors and qualities which are only partially influenced by winemaking. A winery's strategy for winemaking translates into characteristics the consumer values. With today's technology, wineries have more control over the production process than ever before. By classifying production activities according to the qualities they produce in the wine, a winery can monitor how it s processes add value to it s wine. The classification of activities into value-added or non-value-added provides a tool to examine the production processes. Classification can help determine at what cost a certain level of quality is attained. With this knowledge, the ratio of consumer value to winery cost can be improved.

Winemaking activities are classified as either value-added or non-value-added. Value-added activities enhance the product directly. For example, the use of French oak barrels to age a wine directly translates into flavor. Non-value-added activities add no distinguishable product qualities a consumer would notice or value. Non-value-added activities are often unnecessary overhead activities, such as storing empty barrels, movement of wine between facilities, and inefficient downtime in production facilities.

One particular winery recently examined the value added by using 50 percent new French oak barrels for each vintage of Cabernet Sauvignon. The winery wished to maintain a high reserve quality, but could not readily determine the cost per vintage of the new barrels. They first realized that they were not associating the French barrel cost specifically with the reserve Cabernet Sauvignon due to two factors: their barrel lives did not reflect that they physically retired the barrels after one vintage aging of two years; and they averaged French barrel costs with American barrel costs. The American barrels were mainly used for a popular variety separate from the winery's reserve products.

"Winemaking activities are classified as either value-added or non-value-added."

After the value-added costs were identified, the winery determined that they needed a new strategy to improve the gross margins on their reserve product. They chose to extend the use of the barrels on another variety, Pinot Noir. This reduced the winery's losses from barrel sales and spread the barrel cost among varieties. The value of French oak translated into qualities they desired in their reserve wine, yet not at their marginal production cost.

The goals of value classification of the production process are improvement of the product quality for the consumer, expansion of value-added activities, and reduction of non-value added activities and reduction of waste. Value classification of winemaking provides an important basis for evaluating how attributes of the winemaking process become attributes of the wine product.

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