

MKF



WINE INDUSTRY

BUSINESS UPDATE

Higher Profits For Premium Wine

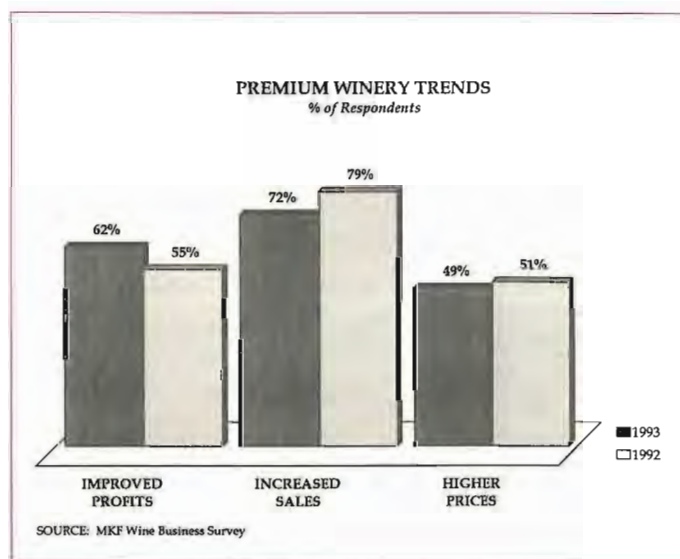


Vic Motto

1993 was a good year for the premium wine business. The MKF wine business survey of over 200 California premium wineries shows that a majority had higher sales *and* higher profits in 1993. The best news is that 62% of the wineries surveyed improved their profits in 1993.

The rate of volume growth is slowing down for many wineries as the industry matures, but profits are improving.

The graph shows the percentage of wineries that had improvements in volume, sales, profits and prices. Overall, premium wine grew more slowly in 1993 than in 1992, but the higher price segments had very strong growth.



MARKET SEGMENTS:

The growth of *Popular Premium* brands slowed considerably. These *varietals* are all *fighting* to at least maintain their share of the market. Some of

the smaller brands in this segment are rapidly losing ground. Prices are up slightly, and profits are good for the strong large producers.

The *Super Premium* segment is certainly the most volatile - both up and down. There are many surprises in this category. Several older brands that were previously struggling, are now coming back with strong sales and profit growth. This is due to a combination of good value and hard selling. Some of the brands in this segment are retrenching. Although 28% of the category had lower sales, half of this group took price increases and showed profit improvement. There are successful wineries of all sizes in this segment - many with product or market niches, others based on broad distribution. Average prices slipped about 2% overall for the category, but profits increased for a number of reasons.

The *Ultra Premium* segment is still hot, and had the strongest growth. There are many successful high-end boutiques. The small winery is alive and well in the higher price categories. There are also some *very* successful brands that have both high prices (over \$100 FOB) and high volume of 30 to 100 thousand cases. This group is very profitable. There is another group of brands in the same size range who are regrouping. These wineries are working very hard to increase prices and improve sales techniques in order to join their more profitable competitors.

These trends are very positive and show some real strength in the premium sector of the industry. The details show that the industry is becoming much more competitive as well.

OUTLOOK:

The strong overall showing for premium wine is encouraging. Most of the wineries in our survey are bullish for 1994. The survey results in the table show that most expect sales increases and improved profitability.

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CONSUMER DIRECT: MORE BANG FOR YOUR BOTTLE!



Michael Young

It has been nearly fifteen years since abolition of fair trade laws in California. Up to then, retail prices for California wine were the same throughout the state. This event has had profound effect on the selling of wine in California and throughout the USA. The virtual explosion of consumer-direct selling heavily based on price has been a direct development related to that court decision freeing pricing.

This trend toward direct sale has been accelerated by other fundamental changes in the wine business. Since then, the number of wineries (especially small brands) has grown dramatically, the number of distributors has substantially decreased, and the development of warehouse clubs and other large retailers taking comparatively small markups has exploded. By some estimates, the warehouse clubs in California may now be accounting for up to 20% of wine sales. This may not yet be true outside California, but these clubs have large expansion plans.

Let's examine in more detail the development of the consumer-direct trend, and consider whether it may be suited to your winery. The primary techniques presently involve telemarketing and mail order sales. This means that the quality of one's contacts is vitally important. These can be developed by studious maintenance of lists from winery visitors, consumer contacts

at shows or while traveling, or may also be purchased from list rental firms. Nearly all consumer direct operations depend heavily on computer technology to maintain lists and keep track of many other details. Leveraging information systems to yield customer service benefits is a key element. Improved customer service means added value, and usually means convenience in the consumer-direct wine business. If your winery is willing to invest in the effort and expense required to get going, this approach can be successfully used. A recent sampling of North Coast California wineries showed that a large number have at least fledgling operations based on telemarketing and/or mail order.

However, because of the start up costs and time, there have sprung up a number of companies that specialize in the telemarketing and mail order sales of wine. These companies may act essentially as brokers for a group of wineries, and take a commission for each sale. They also buy outright from various wineries, and sell to the customer at whatever can be arranged. Since larger wineries tend to have established distribution networks, the trend is for this type of telemarketing-mail order company to offer wines from smaller wineries who lack fully developed distribution arrangements. Currently, in Sonoma and Napa counties, there are at least 10 to 15 different companies of this type. Some of these companies have front-end retail operations while others are solely telemarketing and/or mail order. Even large traditional wholesale distributors are using these techniques. Telemarketing allows them to make contact with customers who may be too small or out of the way to receive attention from the regular street sales force.

One of the early pioneers in the consumer-direct business was Windsor Vineyards in Sonoma County. Based heavily on personalized labels, as well as a brand name that was not available at retail, this winery has become a sizable factor in this business in Califor-

nia and in numerous other states. Today, it has a retail outlet in New York state, as well as an office in Southern California. Sales continue to show strong growth.

Another recent success story is the wine mail order firm of Geerlings and Wade. Begun in the mid-eighties and based in Massachusetts, this firm has grown quickly. It emphasizes European wines, and was cited in 1992 as #336 on Inc. Magazine's list of 500 fastest growing private companies.

It is impossible to know the actual size of the consumer-direct business. Clearly it is growing! From just the companies mentioned above, we estimate the retail value to be at least \$40 million. There are undoubtedly numerous other companies in existence. (The increase in magazine advertising confirms this.) The overall retail value is likely several multiples of the \$40 million estimate. The category has become large enough to merit consideration by nearly all wineries.

The basic economics of this type of operation are illustrated as follows (nearly all sell at some slight discount from normal retail):

| | Telemarketing | Mail Order |
|--------------------|---------------|------------|
| Sales | 100% | 100% |
| Cost of sales | 35% | 35% |
| Gross Margin | 65% | 65% |
| Marketing | 10% | 10% |
| Phone bill | 7% | - |
| Telemarketer wage | 18% | - |
| Catalogues/postage | - | 25% |
| Freight/shipping | 5% | 5% |
| Administration | 5% | 5% |
| Expenses | 45% | 45% |
| Pre-Tax Income | 20% | 20% |

The above is illustrative only; each operation must develop its own strategy and cost structure, and each category of expense can vary widely, but it does show that the economics can work reasonably well.

The US mail-order industry is now estimated to be in excess of \$200 billion! Wine is just beginning to play a significant role, but the future looks quite positive.



BALANCE: THE KEY TO SUCCESS IN THE WINE BUSINESS



Mike Fisher

Profitability can be elusive for many vintners, but for others financial success seems easily achievable. No one statistic or trait can be identified with profitable wineries. However, profitable wineries do have critical elements such as price, volume, distribution, costs, etc., in "balance."

Defining what this balance means can be difficult, but based on the financial results of numerous wineries, both unprofitable and profitable, we have developed three winery profiles that use drastically different methods to obtain similar profitability. These three winery profiles are depicted above in the chart of key statistics.

WINERY A -

High Prices and Costs - Relying on Consumer Pull

Winery A produces two wines, Chardonnay and Cabernet. They have developed the reputation for high quality wines with unique characteristics. The retail price of these wines is in the range of \$20 to \$25 per bottle and the winery sells a higher percentage at retail. Everything is done in the production process to enhance quality, including high cost (and quality) grapes, a high percentage of new barrels, and expensive packaging. Most of the marketing costs are related to creating and maintaining the winery's image and principally include such things as pub-

lic relations, hospitality and promoting "the story." It is a high profile winery with a strong consumer following.

This winery closely monitors production volume versus sales demand so that demand always exceeds supply, but only by a manageable margin. Typically wineries of this size (15,000 to 20,000 cases) have extreme difficulty obtaining profitability. In this example however, the winery has been "pulled" to this size by high consumer demand for its wine. Consequently, they operate more like a winery of smaller rather than larger size.

WINERY B -

Medium Pricing and High Quality - What's in the Bottle Sells the Wine

The product line consists of some high-end but mostly medium priced wines with little retail. The winery's focus is on two varieties with multiple bottling and pricing of each variety. Even though there is a strong focus on quality, more modestly priced grapes are used. The production facility is efficient and the winery has gained a high level of consumer acceptance. Because of being recognized as having a high value-to-price ratio by the consumer the high costs of maintaining the brands are not necessary.

Margins are lower but are offset by lower operating expenses per case due to a much higher volume than Winery A. The wine is widely distributed nationally and internationally. Consumer availability is a critical component of the balance.

| | Winery | | |
|-------------------------------|----------|----------|----------|
| | A | B | C |
| BALANCE SHEET (000's): | | | |
| ASSETS | \$ 3,300 | \$ 7,000 | \$ 5,100 |
| DEBT | \$ 500 | \$ 4,000 | \$ 2,000 |
| EQUITY | 2,800 | 3,000 | 3,100 |
| Debt & Equity | \$ 3,300 | \$ 7,000 | \$ 5,100 |
| CASES SOLD (000'S) | 15 | 40 | 50 |
| PER CASE: | | | |
| Sales | \$ 167 | \$ 88 | \$ 60 |
| Cost of Sales | (60) | (45) | (32) |
| Margin | 107 | 43 | 28 |
| Operating Expenses | (70) | (23) | (14) |
| Operating Income | 37 | 20 | 14 |
| Interest | (3) | (8) | (3) |
| Pretax Income | \$ 34 | \$ 12 | \$ 11 |
| RATIOS: | | | |
| Pretax Return on Equity | 18% | 16% | 17% |
| Case Inventory/Sales | 3.67 | 2.00 | 1.70 |

WINERY C -

Low Price and Low Costs - A Small Winery Operating at High Volume

This winery produces mid-priced wines with only a small amount of higher priced wines. Numerous varieties are produced but a high percentage of volume is in two wines. Less expensive grapes are used, with some wine purchased in bulk. A highly efficient vineyard operation makes up a high percentage of the grapes. The production facility is high volume and efficient with high inventory turn over. All costs are controlled closely with frequent cost/benefit analyses. The winery is organized and operated as a much smaller winery with a limited staff, requiring each position to perform multiple duties. An entrepreneurial spirit runs through the organization, enhanced by a profit sharing/incentive bonus plan.

The effective use of a national distributor requires little marketing expense. A large percentage of wine is sold through chains, grocery stores and wine-by-the-glass programs.

The only statistics similar among these three profiles are those which measure profitability. Pretax income is +/- \$500,000, equity investment is +/- \$3,000,000 resulting in a return of +/- 17%. All other ratios and statistics are drastically different. Average

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PROFITS, Continued...

| MKF WINE BUSINESS SURVEY | | | |
|--------------------------|-------------|-------------|-------------|
| % of Respondents | | | |
| 1993 vs. 1992 | | | |
| | Sales | Prices | Profits |
| Up | 72% | 49% | 62% |
| Down | 26% | 34% | 23% |
| Flat | 2% | 17% | 15% |
| Total | 100% | 100% | 100% |
| 1994 Outlook | | | |
| | Sales | Prices | Profits |
| Up | 82% | 51% | 71% |
| Down | 6% | 6% | 2% |
| Flat | 12% | 43% | 27% |
| Total | 100% | 100% | 100% |

BUSINESS ISSUES:

Despite their strong showing and positive outlook, winery executives see challenges in 1994. The top six business issues expressed by winery CEOs are:

1994 1993

| Rank | Rank | Wine Business Issue |
|------|------|---------------------------|
| 1 | 1 | Marketing and Sales |
| 2 | 7 | Distributor Consolidation |
| 3 | 5 | Profitability |
| 4 | 3 | Price Pressure |
| 5 | 2 | Phylloxera |
| 6 | 9 | Government Regulation |

BALANCE, Continued...

case price ranges from \$167 to a low \$60 per case. Winery A spends over five-fold on operating expenses per case compared with Winery C and has a production cycle requiring over twice the inventory level (cases to sales) as Winery C.

The wide range of these statistics between wineries which experience similar profitability makes reliance on wine industry "standard" statistics (such as an average case price, margin %, marketing cost per

Marketing and Sales is still the number one issue, and *Distributor Consolidation* has moved up from 7th to 2nd. Many expressed frustration with the competition for distributor attention. A number of wineries have dramatically increased direct contact with the trade to get around this problem. Many feel that this will precipitate more flexible arrangements with distributors as wineries have more direct representation in the market.

Profitability issues include marketing costs, profit margins and optimum product mix. More wineries are forsaking volume growth for profit growth. Many wineries are now at capacity, and need to work on improving prices, quality of distribution, and profits.

Anxiety about *Phylloxera* has waned, as replanting continues. Concerns remain about the available grape supply and the availability of financing for replanting. The ubiquitous government regulators are higher on the list due to growing bureaucracy, taxes, trade barriers, and anti-alcohol sentiment.

CONCLUSION:

Every year, the viability of the premium wine business has improved. Individual wineries have

case, etc.) difficult when comparing a specific winery performance.

There is more than one strategy that can be used to succeed in the premium wine business, but combining these different strategies in an unbalanced way can change the results drastically. Obviously one can't sell wine at a lower price and incur high production or marketing costs.

Those who do the best job of developing and maintaining this

mixed results, but the overall business shows strong growth. It's apparent that the keys to success today are to balance price and volume with the market segment, and to have a strong presence with the trade. The *polarization* of the industry continues, with many mid-size wineries struggling because they are the wrong size for their market segment.

The wine industry is maturing, and becoming more sophisticated and competitive. Many say that in some quarters, wine is becoming more of a mainstream consumer product. If it weren't for government restraint of trade, the industry would probably be even bigger. The increased emphasis on stronger marketing and sales is working to overcome this. The California premium wine industry is alive and kicking, with good prospects for the future.

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