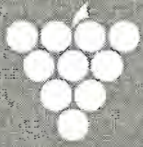


MKF



WINE INDUSTRY

BUSINESS UPDATE

RECORD PROFITS FOR PREMIUM WINE

Vic Motto

Virtually every profit record was broken in 1996 for premium wine as shown by the MKF Wine Business Survey of premium wineries. Survey respondents included over 200 wineries, representing over 67% of premium wine sales. The premium wine industry broke all profit records in 1996, including:

- ❖ The *largest* number of profitable wineries – 95% of all wineries
- ❖ The *biggest* increase in profits – 33% overall, with many individual records broken
- ❖ *Record levels* of profitability, both in total dollars and percent of sales

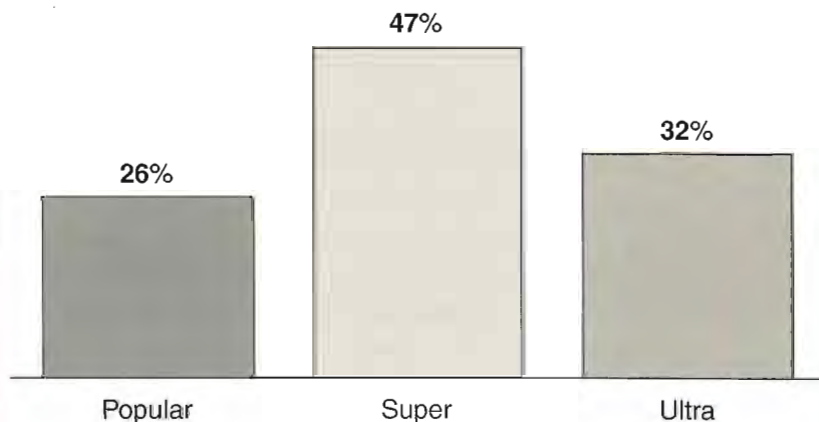
The reasons for these impressive records were many: Two-plus years of record sales growth elevated many wineries to levels of more efficient operation through economies of scale, primarily in sales and marketing efficiency. Many wineries are finally



It's a great time to be in the wine business!

Photo by Dona Bonick

Premium Wine PROFIT GROWTH


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reaching some level of maturity, and some are operating at or near their target capacity. This allows them to realize more efficient, profitable operations.

Price increases were a factor, although overall prices increased only 5%, which is rather low, considering all the discussion about wine prices. However,

Continued inside

prices also increased 5% the previous year, so the effect is cumulative, and it exceeds the level of cost inflation. In addition, expenses for programming, samples, and some other promotional spending, generally decreased on a per case basis.

California premium wine has attained more stature in the market. Selling wine was easier (and therefore less costly) due to high demand, high quality vintages, favorable publicity about wine, and the cumulative effect of hundreds of vintners promoting and building the market.

Certainly, the success of wine has also created substantial increased profits for distributors and the trade as well. This is helping to increase the importance of wine in their product mix, which in turn will help the wine industry to continue growing.

Profit Segments-

The most profitable wineries once again, were Ultra Premium wineries. Generally, the higher the average price (sales per case), the more profitable were the wineries, which has always been true. Of the three traditional price segments, Super Premium wineries had the highest percentage increase in profits. Marketing economies of scale contributed substantially to this. The combination of high volume and high prices (vs. direct competitors) is a very powerful tool for making money.

The inverse is true as well. Lower priced Popular Premium wineries had the lowest level of profitability (measured using earnings before interest and taxes - "EBIT" - as a percent of sales). Popular Premium percentage profit is about half that of Ultra Premium wineries – but they make it up in volume.

The following tables analyze profit trends by price segment and by winery size. Generally, the

PREMIUM WINE PROFITS

	PROFIT GROWTH	PROFITABILITY	
		Average (EBIT % of Sales)	Best
By Price Segment:			
Ultra Premium	32%	24	52%
Super Premium	47%	22%	37%
Popular Premium	26%	13%	20%
<i>Overall</i>	33%	17%	52%
By Winery Size (Cases):			
2 - 7 million	31%	17%	37%
250,000 - 750,000	58%	11%	25%
100,000 - 249,000	28%	12%	33%
50,000 - 99,000	42%	26%	52%
25,000 - 49,000	6%	21%	43%
10,000 - 24,000	202%	12%	31%
Under 10,000	47%	23%	50%

smaller wineries are more profitable (as a percent of sales), because they tend to be higher-priced. Also, they sell a larger percentage of their wine at direct retail prices, which can be much more profitable. An exception to this smaller-is-more-profitable principle is the 50,000 to 99,000 case category. This is the most profitable size category because it includes a number of wineries who sell a lot of very high-end wine.

The most interesting category is the 10,000 to 25,000 case range. As a category they doubled their profits in 1996! However as a group, they are still among the least profitable. This is the size range that we have referred to for several years as the *Dead Zone* (with apologies to some of the very successful exceptions in this category). Wineries of this size are often too big to be "small" boutiques, and yet too small to efficiently operate as a national brand.

The difference is that now the vote is split: with half saying that prices are too high, and the other half saying that they need to increase prices. Both may be right.

The Grape Shortage has now turned into the Wine Shortage. The new issue of *Inventory Shortages* is hopefully temporary. Shortages are leading to concern over *Imports*. Some of the more telling comments on these subjects are quoted below:

"We need to maintain distribution, visibility and income level, despite inventory limitations."

"We must find ways to maintain cash flow during periods of short supply."

"California wineries bottling foreign wine under previously domestic labels are asking the trade to place them in the California section. These selfish SOB's are undermining the long-term best interests of the California wine industry."

New in this year's survey is the subject of *Estate Taxes* as a business issue. It's not unusual to see estate planning surface as an issue as businesses become more profitable, and as the next generation gets more involved in the business. This also ties in with a survey done by the *Family Wine Business Forum*, where over 80% of the vintners expressed the desire to keep their wineries in the family and vice versa.

TOP GOALS FOR 1997

The top goals for 1997 follow the top issues expressed by vintners:

- ❖ Acquire and/or plant more vineyards
- ❖ Improve and sustain profitability
- ❖ Long-term balance of supply and demand
- ❖ Higher wine quality

❖ Improve quality of distribution

Some of the specific survey comments related to these and other goals are:

"We need to increase the base of wine drinkers. Toward that end, the Wine Market Council deserves to be supported."

Goal-

"Continue to build sales relationships."

"Keep distributors excited about our brand."

"Develop better marketing and sales programs."

"How can we manage the short-term supply problem, while limiting the long-term exposure when the cycle reverses?"

"Many California grapes are overpriced for the world market. Strong demand can only be met with imported wines."

"The flap over "appellation" brand names will hurt a lot of wineries."

"Allocate wines for the best interest of the future."

"Watch the bottom line."

WHAT'S AHEAD?

With success comes problems, opportunities and challenges. For years, California premium wine was the underdog, so it took a major effort to make a go of it. An underdog can never rest. Now California is the premium wine leader, so everybody's gunning for it. The imports are coming with varietal names, California-looking

Continued back page

packages and California-sounding appellations. Low end products are developing packages that look like high end products. Successful brands are being copied. A leader can never rest.

It's time to take your winery and the industry to the next level. There has never been a more opportune time in this industry to build for success.

But what about the shortages? What about the imports?

That's exactly why this is a good time to go for it. The market is wide open and red hot with excess demand. Shortages will keep it that way for now. And when you have less wine to sell, every sale and every customer becomes more important. When wine is plentiful, wineries use every tactic possible to sell wine. When supplies are tight, it's time to be more strategic.

New competition from imports will help you. First they will raise the visibility and awareness of wine. Second, they will bring new creative marketing approaches that will elevate the quality of wine marketing. Finally, they will bring products that we can successfully position our products against.

It's going to be fun.
You'll love it!

The changes are already starting.

Larger wineries are concentrating on market share, both through volume growth and through product line extensions and/or added brands. The goals are to leverage a large sales and marketing organization and to become more important to the consolidating distribution system and retail market. Toward this end, they will expand their marketing activities by adding marketing professionals from other successful industries, increase their advertising budgets –

substantially in some cases, and by doing more merchandising and cross-promotion.

Smaller wineries are concentrating on customer relationships, the lifeblood of small wineries. They will do this with more relationship building, more specific distribution methods and goals, and more sophisticated information technology, all with the objective of maximizing individual customer profitability. In some cases this "customer" is the wine consumer, and in other cases the "customer" is a specific trade account or group (type) of trade accounts.

Overall, the California premium wine industry is moving more toward creating more customers, making better wines/better values, and making wine more visible, more available, and more approachable. To accomplish this, we need more market research to better understand and reach the consumer, to better understand the potential market for wine, and to develop better programs to appeal to those markets.

It's a great time to be in the wine business!

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ANOTHER BIG GROWTH YEAR

In spite of grape shortages, premium wine sales still grew at double-digit rates. The premium wine market continues to outpace the general economy. The overall growth rate in sales, cases, and prices was virtually the same as last year.

Sales By Price Segments-

Ultra Premium wineries had the largest price increase at 7% overall, which is less than the 13% price increase the previous year. This brings the average price for Ultra Premium wines to right at \$20 per bottle at retail. Case sales growth increased to a rate of 8% vs. 3% growth the previous

year. But 1997 is the year the grape shortage will hit this category. 1997 case sales will decline for many Ultra Premium wineries because now they no longer have the wine to sell.

Once again, Super Premium wineries had the strongest growth in both sales and cases, but at lower growth rates than the previous year. Price increases averaged 5% vs. 3% the previous year. The average retail bottle price has increased to \$12, with more wineries breaking the sacred \$10 price point. Will this dampen future growth?

Popular Premium wineries are helping to bridge the gap here by providing some of the good quality premium "Coastal" products at competitive Popular Premium prices, as well as California appellation magnums that still offer good value. These products contributed to an increase in the volume growth rate for this segment to 12%, up from 8% the prior year. Combined with a 5% price increase, this led to a strong 17% growth in sales revenue, up from 11% previously.

PREMIUM WINE SALES GROWTH

	SALES GROWTH			SALES Per Case
	\$ Sales	Cases	Prices	
By Price Segment:				
Ultra Premium	16%	8%	7%	\$117
Super Premium	18%	13%	5%	\$74
Popular Premium	17%	12%	5%	\$38
Overall	17%	12%	5%	\$48
By Winery Size (Cases):				
2 - 7 million	17%	12%	4%	\$42
250,000 - 750,000	21%	19%	1%	\$58
100,000 - 249,000	14%	3%	10%	\$70
50,000 - 99,000	16%	5%	10%	\$105
25,000 - 49,000	7%	(6%)	14%	\$134
10,000 - 24,000	5%	7%	(2%)	\$94
Under 10,000	31%	16%	13%	\$171

Sales by Winery Size-

In general, the bigger wineries are growing faster in sales. They're also acquiring vineyards and planting faster than smaller wineries. The fastest growth category however, was the small boutique – under 10,000 cases. This group had strong growth combined with very high prices. Let's hope for this group that the stock market stays up there.

The next size category up is the infamous *Dead Zone* (10,000 to 24,000 cases). These wineries as a group had much weaker growth across the board than their smaller brethren. They were also the only category with a *decrease* in prices.

The next category up, 25,000 to 49,000 cases, is the only one with a *decrease* in volume. Are they leading indicators? It's interesting to note that

Continued next page

where the volume softens in this strong market, prices tend to go up. One way or another, most wineries have managed to keep that revenue coming in. This category is the most dramatic example of that principle.

TOP BUSINESS ISSUES

Oh, how the world changes! Three years ago, the top concerns for vintners were being able to sell wine, get attention from distributors, and make some improvement in pricing and profitability. Today, sales are booming, distributors are begging for more wine, and prices and profits are at an all-time high.

Now, the issues have changed. The top concerns expressed by vintners are related to the *Grape Supply* and *Grape Prices*. These issues were mentioned by almost every vintner, and mentioned more than twice as often as any other issue. The primary concern was related to supply: too little now, and potentially too much later. Some of the comments received are quoted below:

Grape Supply-

"We need less reliance on short-term fruit sources."

"Will the coming flood of grapes turn the market inside out? This is a traditional farm economy roller coaster, and in a free market may be unavoidable."

Grape Prices-

"Growers have stars in their eyes."

Marketing and Sales is a perennial top issue, but the underlying issues have evolved over the years. A few years ago, the primary concerns were to increase sales, and to get more distributor attention. Now sales have improved, and so have some of the wineries' methods for working with distributors. Today, the concerns expressed are more strategic, with issues such as visibility, reputation, image, market share, and consumer education emerging as the important issues.

This is a good sign that the industry is continuing to mature, and to grow in success and in business sophistication. Many would agree that we need to use *Profits* in part for more *Promotion* to sustain the long-term growth of the business.

Legal and regulatory issues related to *Consumer-Direct Sales* and interstate shipping are growing in importance to

wineries of all sizes. Many wholesalers and retailers are concerned that this will lead to the demise of the three-tier system. The core issue however, is the *mandated* use of the system, rather than the system itself.

In spite of record profitability, *Profits and Costs* are concerns of many. Of course, profitability is a new experience for some, and everyone should be doing well in a market like this. The real issue is to achieve reasonable long-term and sustainable profitability.

Concern over *Wine Prices* is still a top issue.

TOP WINE BUSINESS ISSUES

Rank	1997	3 Years Ago
Grape Supply / Prices	1	Not Listed
Marketing and Sales	2	1
Consumer-Direct Sales	3	Not Listed
Profits and Costs	4	3
Wine Prices	5	4
Inventory Shortages	6	Not Listed
Replanting	7	5
Imports	8	Not Listed
Distributors	9	2
Estate taxes	10	Not Listed