

**MKF****Wine Industry  
UPDATE****MOTTO, KRYLA & FISHER**  
Certified Public Accountants*"Wine industry financial, business and tax ideas."*

## Foreign Investors In California's Premium Wine Industry

*Mike Fisher, CPA & Partner*

I recently had a chance to discuss the topic of foreign investment in the California premium wine industry with syndicated wine columnist Dan Berger. Dan writes for the *L.A. Times* and numerous other publications.

Motto, Kryla & Fisher represents a number of foreign-owned wine interests. With this perspective, Dan and I discussed who these foreign investors are, why they have chosen to invest in the California premium wine industry, and how their investment affects the future of the industry.

A consistent trait among foreign investors is their ability to secure adequate capital to finance their investment. "We are seeing a revolution in terms of grape growing, including more business sophistication and the introduction of high technology. Large, well-financed companies are the most likely to realize and reap the great benefits of this technological revolution," observes Berger.

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*Generally, foreign investors aren't high risk takers or pioneers.*

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In addition to being well-financed, most foreign investors have a long-term perspective and are willing to wait many years before expecting a return on investment. As Berger notes, "This is a business that requires time. You only produce a product once a year. Patience is the greatest virtue in this business."



*Well-known syndicated wine journalist, Dan Berger, (left) and Mike Fisher, MKF, discuss the effects of increased foreign ownership on California's premium wine industry.*

Beringer Winery provides an example of how patience pays off. "Beringer has been successful for a long time, but two decades ago, Beringer's parent company Nestle Corporation invested a tremendous amount of capital into the property. The winery probably wasn't profitable for seven to nine years. Now, everyone is looking at Beringer as the prototype classic success story. Many winery owners would like to accomplish what Beringer has, but not at the price of making a seven to nine year investment before realizing a return," contends Berger.

Generally, foreign investors aren't high risk takers or pioneers. Few foreigners have invested in vineyards outside the known premium wine producing regions of California. Realizing profitability may be many

years away, they reduce their chances of making a mistake by buying vineyards in appellations of known quality. Foreign investors also stay with the proven varieties such as cabernet and chardonnay.

*Continued page 4*

### IN THIS ISSUE

**Eye On Washington**—Label Design Deductions/IRS Wine Industry Audit Team ..... Page 3

**Profitable Winery Profile**—Part III, Managing a Successful Marketing Plan ..... Page 3

**How Do You Measure Up?**—Projecting Winery Capital Needs ..... Page 2

## Projecting Winery Capital Needs



Vic Motto,  
CPA & Managing Partner

During a recent MKF seminar on small winery management we made the point that many wineries

underestimate the capital needed to bring their operation to its planned capacity.

The accompanying graph illustrates the capital needs of a 30,000 case premium winery. The biggest surprise for some is the amount of capital needed for wine inventory. The cost of wine inventory can ultimately *equal or exceed* the cost of property and equipment. The

surprise comes as this cost builds up over time. Some wineries finance inventory build-up entirely with debt. A problem can occur, however, when the winery cannot adequately support the amount of debt needed, and equity capital is not readily available.

*...many wineries underestimate capital needs...*

The solution is to anticipate the inevitable inventory build-up and include this cost in planning long-term financing for the winery. The financing should include additions to equity as required capital needs increase.

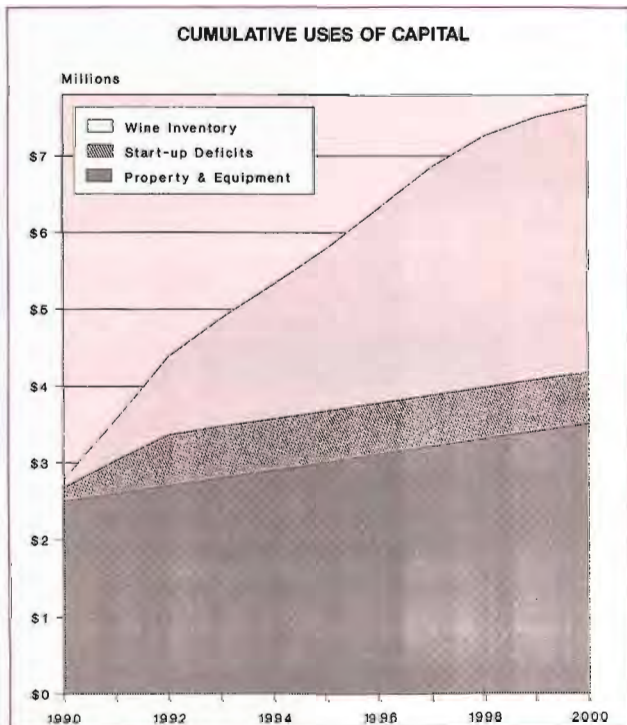
The MKF Winery Model demonstrates a simple approach to calculating the required investment in wine

*The biggest surprise for some is the amount of capital needed for wine inventory.*

inventory. The cost for each wine is computed separately based on (A) the planned number of cases to be produced annually, (B) the number of vintages in inventory (depending on bottling and release timing), and (D) production costs per case. Based on these assumptions, the number of cases in inventory and the inventory costs are calculated as shown. The result is the total inventory investment required once the winery is producing and selling at capacity.

Try this calculation for your winery. The answer may surprise you. ♦

## MKF WINERY MODEL



**PROJECTING REQUIRED WINE INVENTORY**

	Chardonnay	Cabernet	Total
<b>EQUIVALENT CASES</b>			
ANNUAL CASES PRODUCED	A		
	20,000	10,000	30,000
NUMBER OF VINTAGES IN INVENTORY:	B		
Bulk	1.0	2.0	
Bottled	1.5	1.5	
CASES IN INVENTORY: $A \times B = C$			
Bulk	20,000	20,000	40,000
Bottled	30,000	15,000	45,000
Cases	50,000	35,000	85,000
<b>COST</b>			
COST PER CASE: D			
Bulk	\$36	\$47	
Bottled	44	55	
INVENTORY COST: $C \times D = E$			
Bulk	720,000	935,000	1,655,000
Bottled	1,320,000	825,000	2,145,000
Inventory Cost	\$2,040,000	\$1,760,000	\$3,800,000

## EYE ON WASHINGTON

## Label Design Deductions



*Karen Kryla,  
CPA &  
Partner*

According to a recent IRS revenue ruling, label design costs are not deductible or even amortiza-

ble. The costs you incur for any label design (in-house or contracted) must remain as an asset on your tax balance sheet until you abandon that label design.

What does this mean for most of you?

More likely than not the costs you have incurred for the design of the label currently being used have either been deducted in full in the year the

costs were incurred or have been amortized. The IRS now takes the position that you have done this in error and must change your "method of accounting" to take these previously expensed costs back into taxable income . . . basically the same concept that was used when they required you to re-cost your inventories.

What should you do?

Once again, the IRS is dangling the carrot . . . or should I say wielding the club . . . to encourage compliance with this new revenue ruling.

For those of you who voluntarily comply with this new ruling and file for the accounting change to recognize the additional income, there are two items of relief:

- You can recognize this additional income over a period of

*continued on page 4*

## PROFILE OF A PROFITABLE WINERY

Success Characteristics:  
Part III

*Mike Fisher,  
CPA & Partner*

As the premium wine industry matures, MKF has seen a change in emphasis from production in the 1970s and

early 1980s to marketing in the mid- to late 1980s.

Profitable premium wineries market their wines at appropriate prices — high enough for gross margins exceeding 50 percent which requires a case price of at least \$75 — and quantities — selling annual production every 12 months. Most of these profitable wineries have marketing plans consisting of: 1) goal, 2) plan for implementation, 3) target market or niche, 4) marketing vehicle(s), and 5) marketing costs per case. Sounds basic doesn't it? However, deciding the specifics and *sticking to them* is critical.

*... it makes more sense to be a big player in a few markets than a small player in a large number of markets.*

The concepts of a marketing plan are easy to grasp, but how does a winery develop a system to manage the plan? Annual sales goals in cases should be determined for each available wine. These goals are then allocated to specific markets defined geographically and by customer type, such as retail, wholesale, and distributor.

Only markets where a sufficient demand exists for a pre-determined

*continued on page 4*

## IRS Forms Wine Industry Audit Team

The local offices of the Internal Revenue Service have recently formed a wine industry audit team. There are four individuals designated by the IRS to become specialists in auditing wineries. Two are working out of the Vallejo office and two in the Santa Rosa office. They are making a concerted attempt to become acquainted with the wine industry in order to bring more understanding and expertise to winery audits. In pursuit of this, they have been attending classes at U.C. Davis extension.

Motto, Kryla & Fisher understands from our discussions with them in both casual and audit settings that they have formulated a standard list of "winery audit" questions to help them zero in on possible areas for adjustments. Hot items on their list include:

- inventory costing (especially with regard to the recosting required by the Tax Reform Act of 1986);
- grape contracts;
- wine futures;
- personal usage of winery assets;
- withdrawals of wines for personal use; and
- in conjunction with our most recent audit experience, the new issue of package design costs.

The IRS is finally recognizing the importance of specialization when it comes to the wine industry . . . something that we at MKF have known for a long time. ♦

### *Foreign Investors continued*

There are a few exceptions to this. The Louis Roederer development in Anderson Valley is in a rather unproven appellation for sparkling wine, and Atlas Peak Vineyards (the Whitbread/Antinori/Bollinger project) in Napa Valley has planted the uncommon Italian varietal, Sangiovese.

When asked why there is such tremendous international interest in our relatively small premium wine industry, Berger notes that prime vineyard land is more important than ever and other countries simply don't present the same level of opportunity for purchasing that land and returning a profit as does California's premium wine industry. "Consider the Champagne district where plantings have increased dramatically in the last 20 years, but the return on grapes hasn't increased as greatly as the cost of purchasing and planting the land."

*"Patience is the greatest virtue in this business."*

Land in Champagne is very expensive and as a consequence the market price for chardonnay is \$2,800 per ton. For wine producers to recoup their investment, a bottle of that wine has to sell for a minimum of \$28 per bottle — based on the old conversion factor of one percent of the tonnage price. At \$28, the wine must then compete with wines in this country that sell for half the price. Even at today's prices of \$1,500 per ton, our grapes in Napa and Sonoma counties are almost half the price of French chardonnay. Additionally, we are producing wines of equal quality to an eager market, continues Berger.

Due to the immaturity of the California premium wine industry, many foreign investors see an opportunity to get in on the ground floor

and take advantage of the substantial growth potential.

The weakness of the dollar compared to other foreign currencies also makes any investment in the United States attractive. "When the yen is 135 to a dollar, it's pretty obvious that there's a sound opportunity for investment," observes Dan.

Our observations portray the foreign investor as adequately financed, running a well-managed operation, and not a high risk taker. He is patient and views his investment as long-term, in many instances spanning generations. As Berger summarizes, "Premium wine is a product of artistic expression with a focus on quality. Foreign investors' goals may seem more altruistic than monetary; however, they still don't like to see their money going through a sieve and it makes economic sense to do it right." ♦

### *Eye on Washington continued*

time not to exceed six years; and

- The next time you redesign your label, you'll be allowed to write off the new costs over a five year period. (Warning — to the extent you "trademark" your label you will not be allowed to take advantage of this benefit.)

For you nonconformists, if caught (we are aware of a recent tax audit situation where this very question was added to the standard list of questions):

- You will be required to take the entire amount of income into account in one year; and
- The next time you redesign your label, you will not be allowed to deduct the related costs until such time as you abandon that design.

When is action required?

To avail yourself of the carrots — or dodge the club — you must file for a change of accounting no later than September 2, 1989. ♦

### *Profitable Winery continued*

quantity of wine should receive allocations. Each market's sales should justify the costs related to a minimum number of annual sales trips and other expenses required to *adequately* service the market. Because premium wine is hand sold, it makes more sense to be a big player in a few markets than a small player in a large number of markets.

Once marketing goals are established, the winery should have a reporting system through which timely, accurate and frequent (monthly) reports are produced comparing actual sales to goals for each market. The system should also track total and per case marketing costs per market.

With this reporting system the winery can react promptly to market changes and meet the annual goals so critical to the plan's success.

Motto, Kryla & Fisher provides assistance in design, installation and support of systems providing marketing plan management. This topic was discussed during the recent Small Winery Seminar presented jointly by Motto, Kryla & Fisher and Napa National Bank. ♦

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