

MKF**Wine Industry
UPDATE****MOTTO, KRYLA & FISHER**

Wine Industry Accountants and Consultants

*Wine industry financial, business and tax ideas***DOES \$56,000 PER ACRE MAKE ECONOMIC SENSE?***Mike Fisher, CPA & Partner*

I recently was selected to participate in a cost study sponsored by the University of California cooperative extension updating estimated expenditures required to establish and farm a vineyard in Napa Valley (previous study was done in 1982).

The results were striking, revealing the only *economic* reason for investment in Napa Valley vineyards is the expectation of continued escalation of Napa Valley wine prices. Grape prices of \$1,800 per ton at five tons per acre would be needed to break even. Of course, 1988 grape prices, which are directly related to wine prices, were far below this level (Chardonnay averaged \$1,292 per ton) and average yield for Napa County was three-plus tons per acre.



Participants of the vineyard cost study included grower John Baritelle (left); Ed Weber, Napa County Farm Advisor; Mike Fisher, Motto, Kryla & Fisher; and Mary Handel, Executive Director, Napa Valley Grapegrowers Association.

Grape growing in Napa Valley is very expensive and requires a long-term investment philosophy.

The study was based on the purchase of a 40 acre parcel on the valley floor for \$27,000 per acre in which old vines are removed. It assumes a well managed vineyard with all money required for land purchase, development, farming and interest borrowed at 12 percent with a credit against these costs for the value of a less than full crop in years three and four of development. In year five the vineyard is at full production of five tons per acre. Standard spacing and trellising is used with drip irrigation from a

well. Wind machines provide frost protection.

Excluded from the study were additional costs which might be incurred in valley floor development depending on soil type and structure, or grape growing philosophy; and the resulting need for drainage systems, cover crop, extensive trellising or close vine spacing.

Based on these assumptions, costs incurred through year four are in excess of \$56,000 per planted acre. As noted from the pie chart, the bulk of the costs are interest and land.

Also included in the study were annual production costs related to the vineyard once it reaches maturity. These costs total slightly less than \$9,000 per acre.

The bottom line is, grape growing in Napa Valley is very expensive and requires a long-term investment philosophy. With a large percentage of debt based on today's grape prices it would be impossible to purchase land and develop a vineyard. Consequently, vineyard development should be structured to include a substantial amount of equity from very patient investors.

It is anticipated that next year the University of California cooperative extension will sponsor a similar study for hillside vineyards.

A copy of this cost study may be obtained for \$1 from the Napa County Farm Advisor's Office at (707) 253-4221. ♦

See graph on back page.

HOW DO YOU MEASURE UP?

Winery Profit Profiles



Vic Motto,
CPA & Managing Partner

Where does the money go in a premium winery operation? How do you make a profit? The bar chart

compares two ultra-premium profile wineries:

	Start-up Winery	Established Winery
Age—years	5	15
Cases produced	20,000	30,000
Cases sold	15,000	30,000
Sales per case	\$94	\$103

Winery profitability depends in large part on winery maturity and pricing. An established winery is more profitable because of efficiency and momentum. Consider the following:

Pricing: Both wineries have high sales per case. This is imperative. If prices were lower, the start-up winery would have losses; the established winery would have lower profits or perhaps would have been sold.

Winery profitability depends in large part on winery maturity and pricing.

Marketing: It costs a lot more to establish a market than to maintain one. It's very expensive to set up a distributor network, organize an effective sales team, create brand awareness, get good placements and repeat sales.

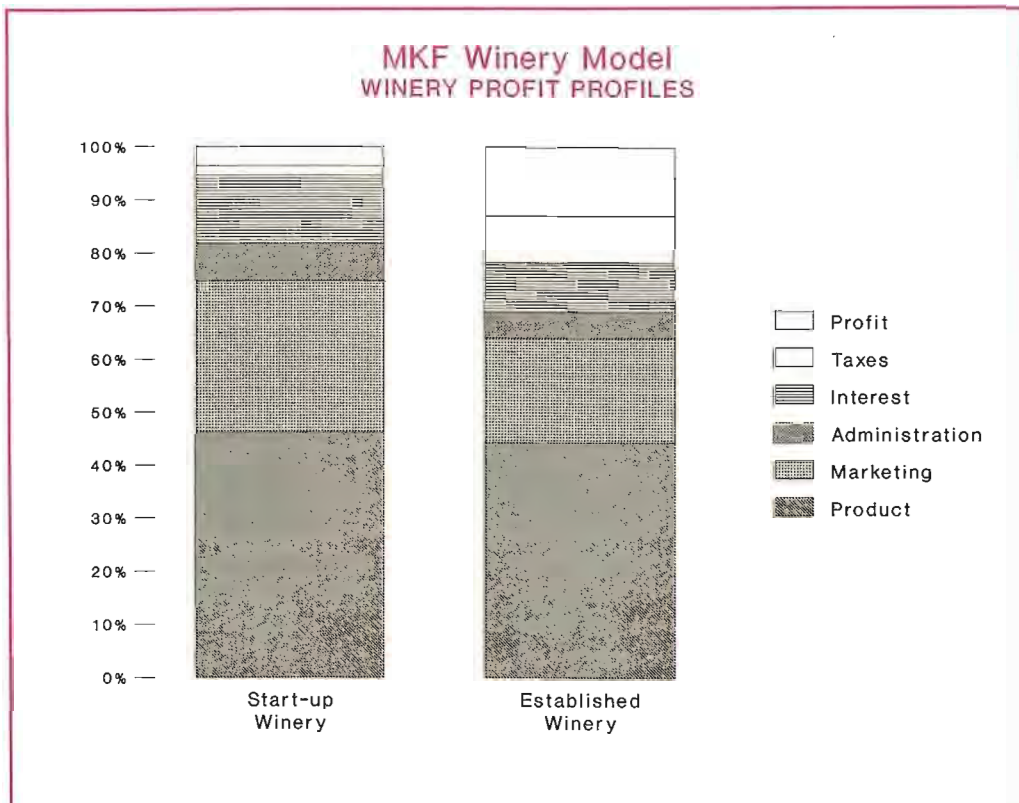
Production: The cost of using assets inefficiently is often overlooked. Inventories must be in balance with sales. A winery must be

producing near capacity to have reasonable fixed costs per case. Both of these factors affect financing costs.

Inventories must be in balance with sales.

In general, an established winery is more efficient only because it is farther up the learning curve. Personnel, systems and procedures are established and operating routinely.

How long does it take to become established? It depends on how often you change your strategy, products, pricing, distribution and personnel. Also, how quickly you approach equilibrium of production and sales. For most wineries, this is the better part of one generation. Then it depends on the kids. ♦



EYE ON WASHINGTON

Tax Issues on Congressional Agenda



*Karen Kryla,
CPA &
Partner*

As of the August congressional recess, hot items on the agenda for the September return include:

- Yet another version of a *capital gains tax break* proposal; and
- proposed substantial limitations to tax-deferred *like-kind exchanges*.

CAPITAL GAINS TAX BREAK

The latest proposal revises the computation of the amount of gain that is taxable rather than applying a reduced capital gains tax rate as originally proposed by Bush. An inflation-based adjustment would be allowed to your original investment

for assets held for more than one year, thus reducing your taxable gain by the amount of such adjustment. For assets held more than five years and less than 10, you would have the option of using an adjustment limiting your taxable gain to no more than 75 percent of the selling price. For assets held more than 10 years, your maximum taxable gain would be 50 percent of the selling price. There would not be a standard "capital gains tax rate." The effective capital gains tax rate could vary from as low as 14 percent to a rate which is only negligibly lower than the current maximum rate of 28 percent.

This proposal has received bipartisan interest, with even an indication from Bush that he may now be willing to consider some type of compromise to his "lower capital gains tax rate" in order to implement some type of preferential tax treatment for capital gains. We may be getting close folks!

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WINERY VALUATIONS

What is Your Winery Worth?



*Debra Sasser,
CPA &
Manager*

With wineries today selling at what seem to be extremely high prices, it's tempting to wonder, "how much is

my winery worth?"

There are many times—other than selling your winery—when the answer to this question is very important, such as...

1. Change in ownership
 - admit a partner
 - ownership distributions
 - employee stock ownership plans (ESOP's)
 - issuance of new stock
 - buy-back of outstanding stock
2. Litigation regarding value of the winery
 - marital dissolutions
 - sales contract disputes
 - mismanagement
 - partnership dissolutions
3. Estate planning
 - total tax impact
 - planned gifts
 - property shifting plans to younger generations

Appraisers are specialists and usually concentrate on certain types of appraisals:

- real property (land, building, vineyards, etc.),
- personal property (equipment, antiques, gems, etc.), or
- businesses (hotels, retail, restaurant, manufacturing, etc.).

Generally, a winery's most significant tangible assets are its building, equipment, and wine inventory.

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Do You Need a Controller?

Kathie O'Dowd, CPA & Manager

As a winery matures and the competitive nature of the wine business increases, vintners may no longer feel they have their "arms around" the day to day activities at their winery.

The organization of a premium winery can be divided into three areas: production, sales and financial. Obviously, to ignore any of these areas can impinge upon a winery's success.

Most premium wineries employ full-time winemakers and sales managers but due to their small size, many find it difficult to justify the cost of a full-time qualified financial controller. A few wineries do employ full-time controllers, while others have part-time consultants performing this function. Financial

decisions can be made by the vintner if ample and accurate information is available; however, this is not always the case. Under these circumstances wineries are likely to consider adding a controller to their management team.

A controller is *responsible* for a winery's internal accounting, which usually includes the following:

- Developing and operating an accounting system that organizes the results of operations in terms that make sense to management.
- Producing accurate financial reports on a timely basis which provide management financial and statistical information and explanations as to why the actual results vary from plan or budget.

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*Tax Issues continued***LIKE-KIND EXCHANGE**

On a sadder note, a recent legislative proposal would substantially restrict "like-kind exchanges." This has been a very popular method of deferring tax when individuals transfer their business investment from one piece of property to another. Current law allows us a great deal of flexibility in structuring these transactions to accommodate almost any transfer from one piece of business or investment real property to another (e.g. from a rental building to a vineyard or vice versa). The proposal would require the property to be "similar" rather than "like-kind"—vineyard for other farm property, residential rental for residential rental, etc. If passed, these new rules would be effective for any transfers occurring after July 10, 1989. If you are contemplating moving your investment under the like-kind exchange rules, make sure your exchange would meet the new requirements should they become law, or be prepared to pay the tax on the transaction. Don't be caught with your investment transferred to a new piece of property without retaining enough cash to pay the tax.

P.S. The due date for filing the accounting change for package design costs as discussed in our last newsletter has been extended from September 2nd to 90 days after the IRS issues another ruling on the method to adopt the change. It seems that the IRS is now reconsidering their original method! We'll keep you posted. ♦

Controller continued

- Assuring all tax returns (payroll, sales, excise, income tax) are prepared and filed on a timely basis.
- Preparing annual budgets and long range plans.
- Maintaining adequate documentation of transactions so they are properly substantiated.
- Managing the winery's cash flow.
- Supervising the winery's accounting and administrative personnel.
- Advising management regarding financial issues.
- Assuming responsibility for all other financial aspects of the operation.

A winery must commit resources to maintaining control over the financial aspects of its business. It's too expensive not to. ♦

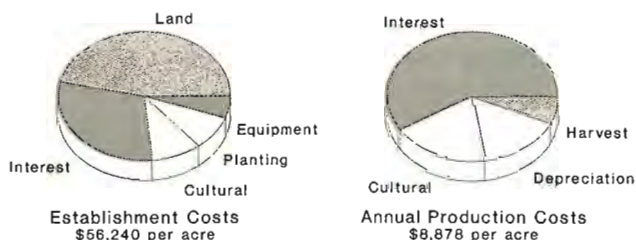
Winery Worth continued

Excluded from these tangible values is the intangible value attached to goodwill. Goodwill in a winery is generated through a combination of brand loyalty, high case price, label recognition and strong market distribution.

The value of goodwill is dependent upon current and *future* ability to generate earnings in excess of an expected return, given the level of investment and risk. Determining future earnings is the key, but projecting the future requires knowing the wine industry and the factors that affect it, along with the specific winery's business strategy which is being valued. Valuing goodwill is the most difficult part of a winery valuation.

In short, because of the substantial value of the goodwill factor involved in recent winery sales, a winery valuation requires much more than a property appraisal to determine its real worth. ♦

**NAPA VALLEY
VINEYARD COSTS PER ACRE**



Source: UC Cooperative Extension
1989 Sample Cost Study

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