

MKFMOTTO, KRYLA & FISHER
Wine Industry
Accountants and Consultants**WINE INDUSTRY****UPDATE***"Wine industry financial, business and tax ideas."***CALIFORNIA CABERNET IS TOO CHEAP**

Vic Motto

"This is a golden age for California Cabernet Sauvignon. Never in its history has California Cabernet Sauvignon been so popular with the American wine-drinking public or so well made."

James Laube
California's Great Cabernets¹

We are at a crossroads for California Cabernet; the wines are great, but the prices are often not adequate to provide vintners with a reasonable profit. Successful Cabernet producers are beginning to recognize that though great Cabernet is expensive to produce, it's worth the cost. However, this message must also be understood by distributors, the trade, consumers and the media.

From the standpoint of demand, supply, quality, cost or value, many California Cabernets are underpriced.

"This is a golden age for California Cabernet Sauvignon."

James Laube

QUALITY AND VALUE

MKF has compiled all Wine Spectator reviews of California Cabernet and Merlot, as well as all Bordeaux red wines for the past year. The results show that California wines are rated *equal* in terms of quality, though substantially *lower* in price than Bordeaux. (See Chart I)



Vic Motto, Managing Partner of Motto, Kryla & Fisher, together with Jim Laube, Senior Editor of The Wine Spectator discuss some aspects of Jim's new book California's Great Cabernets in an appropriate setting.

The Bordeaux wines cost 35% more on average than their California counterparts. Part of the price can be attributed to the Bordeaux image and prestige. Jim Laube believes that California has some work to do in this category, and we think that his book will make a substantial contribution.

We can take a marketing lesson from the Bordelais in creating and maintaining image, controlling quantities and making pricing decisions based in part on quality—both up and down.

SUPPLY AND DEMAND

The supply of great Cabernet Sauvignon grapes is relatively fixed. There are very few places where the best Cabernet is grown, and the total acreage has not increased significantly. Over the past ten years, the total combined planted acres of

Cabernet in Napa and Sonoma counties has grown at an average annual rate of only 2½% while yields have declined.

Chart II shows the average price per ton for Napa Cabernet compared to the total tons produced. The average annual production has remained virtually unchanged for ten years, while the price per ton has increased steadily; and at double-digit rates over the past five years.

Cabernet wine sales have increased as evidenced by the accelerated release schedules and early sell-out of wine experienced by many Cabernet producers.

Jim Laube's book includes information on current prices vs. release prices for 1,200 wines. Our summary of his statistics shows that

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OPTIMUM CAPACITY IN THE PREMIUM WINE BUSINESS



Mike Fisher

In any industry you find various levels of production which show greater profitability. Because of the

dynamics of a specific industry, such as efficiency of manufacturing, competition, standardization of product, marketing, etc., these profitability plateaus exist. Interestingly, in the wine business there is an extreme spread between the smallest and largest producers, from the hobbyist making a few hundred cases to Gallo. Most *premium* wineries have an annual production capacity of 100,000 cases or less. Below this case level we see three distinct plateaus of profitability.

The small winery producing 3-5,000 cases can succeed if: the case price is high (\$150 per case or more), either through high bottle price or a high percentage of retail sales; and the owner runs the business and does most of the work. These operations typically have some employees; however, they are workers and not executives. Generally, this type of operation also owns vineyards which supply a consistent grape source. All selling is done by the owner because low volume allows extensive "hand selling"; and in instances where demand exceeds production, selling is less of an issue. Because of low costs through a simple operation, the owner is able to net a very high percentage of the revenue.

The next level of 25-35,000 cases allows sufficient revenue (\$2-3 million) to justify a general manager and separate departments for production and sales. Once this case

level is reached, the economy of scale from a production standpoint levels off on a cost per case basis, i.e. the cost to produce a case of Chardonnay in a 30,000 case/year winery is not substantially greater than a 100,000 case/year winery. The sales and marketing effort requires a moderate amount of sophistication, and spending \$20 per case allows a budget in the range of \$600,000. At this level of sales the winery is still able to do a substantial amount of "hand selling" through consumer and trade oriented promotion needed to develop image and brand awareness, but does not have to rely heavily on distributors.

If you fall between plateaus you incur the added costs of the higher plateau without the revenue.

The third plateau is in the 75-100,000 case range. This requires a more sophisticated organization in which, as mentioned earlier, production does not become significantly more efficient. Administration, in many cases, becomes less efficient on a per case basis because of the bureaucracy required of a larger organization. The real economies though, are seen in sales and marketing. With a budget in the range of \$1.5 million the winery has much greater influence on distributors. The winery can employ sales reps throughout the country to work with distributors. It allows for greater consumer awareness through the media and the ability to widely distribute the wine because of availability. The winery can still realize a case price similar to the 30,000 case winery.

Once the 100,000 case range is exceeded the winery must go to the next plateau and compete with the likes of Mondavi, Beringer and Fetzer. Sounds like fun doesn't it?

When a winery's capacity falls between any of these plateaus it typically adopts the organizational philosophy of the next higher plateau and its added costs without the revenue. Needless to say, we see exceptions and you may be one; but, if you are anticipating expansion or developing a new winery, it is important to keep these principles in mind. ♦

DECLINING VINEYARDS— A LOSING PROPOSITION

Judy L. Mickle

As you breathe a sigh of relief that harvest is finally over and go about the business of getting vineyards ready for winter, replanting may not be foremost in your mind. Now, however, is the ideal time to assess the overall condition of your vineyards and make critical decisions as to whether you should be replanting.

A vineyard has a finite and measurable lifespan. No crop is produced for the first three years, and an additional three years or more are required before full yields are achieved. Eventually that fruitfulness declines and vines become more susceptible to diseases which reduce yield and quality and ultimately cause vine death.

Reduced productivity in a vineyard means lost revenue—either directly, if you sell grapes, or indirectly if you operate a winery with its own vineyards. Though replanting a vineyard is an expensive proposition, failing to do so at the optimal time will cost you even more.

Lost revenue will begin to exceed replanting costs after a certain time. In order to determine when that time occurs, we calculated the

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EMPLOYEE BENEFITS

CAFETERIA AND MENUS ON UNCLE SAM



Karen Kryla

Cafeteria plans—you've probably heard the term—but if you are a winery or vineyard owner, these

plans deserve a closer look.

What are they—

A way for providing employees and yourself with valuable benefits while saving a significant amount on taxes at the same time.

How they work—

A benefit plan is set up which allows each employee to "redirect" a portion of their salary to purchase benefits from a "menu" of nontaxable benefits offered by the plan. You, as the employer, may also make contributions to the plan on behalf of each employee, but you are not required to do so.

These redirected amounts are not taxable to the employee. Thus, amounts used in the plan to purchase allowable benefits are done so with pre-tax dollars! Better yet, these redirected dollars are not subject to Social Security, Unemployment, Workers' Compensation or State Disability taxes—so you, the employer, also save.

What benefits can be included—

- Accident, health, group term life, disability and dental insurances
- Dependent care assistance (day care)
- Uninsured medical expenses not covered by a typical group medical plan (e.g. plan deductibles)

- Medical and disability premiums otherwise paid by the employee (e.g. dependent coverage)

- Contributions to 401(k) plans (retirement plans)

How you benefit as an employer—

- Save on your payroll costs—You won't have to pay payroll taxes or Workers' Compensation on employee redirected funds.

- Improve employee morale—You're providing a true employee benefit by providing them with a vehicle to pay for ongoing expenses with pre-tax dollars thus increasing their disposable income—a pay raise without a pay raise!

- You can participate too—Owner-employees of 'C' corporations can also participate.

CAFETERIA PLANS—Take a closer look. ♦

ARE YOU AWARE?

One of the positive developments for the wine industry in the last year has been the formation of AWARE, the American Wine Alliance for Research and Education.

The mission of AWARE is: to provide a balanced, comprehensive view of wine's cultural values and proper role in society; to advance research on health and safety issues; to lead in the development of educational programs and socially responsible initiatives; and to provide an international resource center.

You can join with consumers and wine professionals across the country to accomplish these goals. An application for membership is included with this MKF Wine Industry Update. You may also contact AWARE at (415) 291-9113. ♦

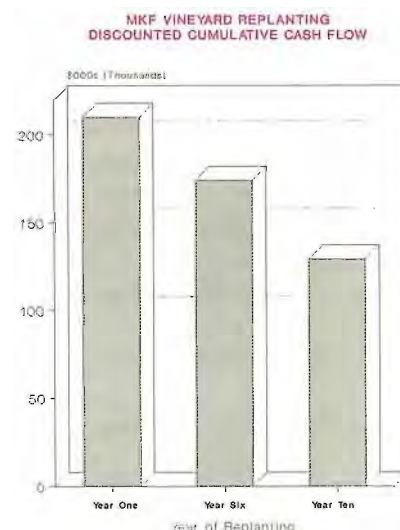
Declining Vineyards continued

discounted cash flows generated from a 10-acre vineyard over a 15-year period which was replanted in year one, year six or year ten after its yields started to decline.

Cash flow was highest when the vineyard was replanted as soon as a decline in yield was noticed. Cash flow was significantly reduced when replanting was delayed. Accumulated cash flow for the 15-year period was approximately \$210,000 when the vineyard was replanted in year one. Cash flow was reduced by 17% to \$174,000 when replanted in year six and declined further to \$129,000 when replanted in year ten.

Our model assumes yields in the old vineyard of three tons per acre declining five percent annually and five tons per acre in the new vineyard at full production. Development and production costs were taken from the UC Extension study done with the assistance of MKF. We used a ten percent discount factor and constant dollars with no escalation of prices or costs.

The results clearly show that replanting costs are more than offset by revenues generated from vineyards kept at maximum yields. Vineyards should be replanted at the first signs of declining yields and any delays in doing so are, in the long run, expensive. ♦



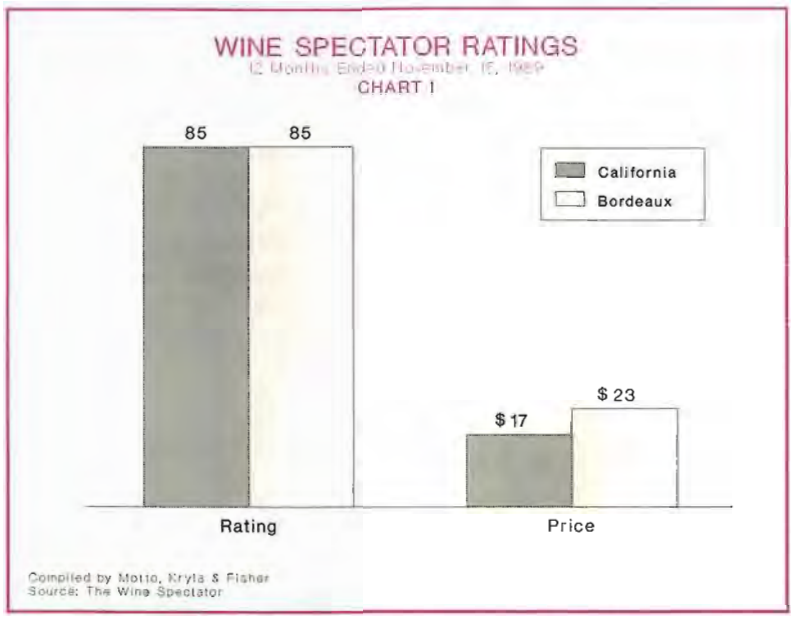
California Cabernet continued

retail prices have already increased 12½ % over original release prices for the 1985 vintage, with many individual brands at 25-50% and more.

Our conclusion is that both demand and prices have been strong. In recent months there has been some softening of wine sales, with indications that this is in large part due to over-buying of the outstanding recent vintages. However, the underlying economics are excellent and we are bullish on the future sales strength of Cabernet.

COST

Cabernet is by far the most expensive wine to produce. Based on a study by MKF, Cabernet costs over one-third more than Chardonnay to produce and market. For this study, the same grape price per ton was used for both varieties. In fact, current Cabernet grape prices are now exceeding Chardonnay prices. The conclusion of the study was that most well-made Cabernets must retail for about \$20 per bottle in order for the winery to make a normal profit.



Although Chardonnay production requires more expensive equipment, Cabernet incurs more aging and storage costs and is more reliant on expensive barrels, which have a relatively short life. Cabernet also requires twice as much winery space because of the barrel aging cycle.

Good locations for growing Cabernet are scarce, and are therefore more expensive. Yields are lower. Unlike Chardonnay, Cabernet grape prices are not influenced by the up

and down cycles of the "fighting varietal" segment. These factors will all create upward pressure on Cabernet grape prices, and the best Cabernet vineyards will increase in price dramatically.

CONCLUSION

Cabernet is too cheap; and great Cabernet is *really* too cheap. However, a few caveats are in order: It takes guts, a good marketing department, great wine, and a willingness to balance supply and demand in order to get a great price. You must have consistent quality and know how to tell your story. And if the vintage is off, bulk out the wine or adjust the price. ♦

¹Laube, James, *California's Great Cabernets. The Wine Spectator's Ultimate Guide For Consumers, Collectors and Investors*, Wine Spectator Press, 451 pp.

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