

**M·K·F**MOTTO, KRYLA & FISHER  
Wine Industry  
Accountants and Consultants**WINE INDUSTRY****UPDATE***"Wine industry financial, business and tax ideas."***WINE SALES ARE UP . . . THE HIDDEN STORY**

We have been blasted recently by news headlines proclaiming:  
*"Pressing Times for Wine Industry"*  
*"Isn't Anybody Drinking Wine Anymore?"* *"Downtrend Continues"*

**Vic Motto**

These headlines were based primarily on one statistic. Case sales of California wine have declined for the third straight year.

The real story, however, has been missed or hidden by these headlines. Although wine volume is down, wine revenues are *up*, and *premium* wine sales have grown at double digit rates year after year. In other words, we are selling less wine for more money than ever, *and* we're selling more premium wine than ever.

It seems that the cliché is true . . . people are drinking less but better . . . and they are spending more to do it. This fits modern times. Wine is the beverage of moderation. We are producing better wines and consumers are emphasizing quality over quantity in more consumer products than ever.

*Premium wine sales have grown at double digit rates . . .*

Why then are hard times being reported by the media? Why, when revenues and prices are at record levels and many wineries are enjoying unprecedented success? It may be that the media are not looking closely enough at the changes occurring in the industry or that they are not close enough to see them. Alternatively, they may be basing their conclusions on insufficient data, or focusing on the wrong statistics, or perhaps all of the above.



*Executive Directors Linda Johnson of Sonoma County Wineries Association and Elaine Mackie of Napa Valley Vintners discuss the premium wine market with Vic Motto.*

Reliable industry statistics are hard to come by. Overall industry totals are not enough. We need information in cases and dollars by segment, product type, price category and brand to really understand what is happening in the industry. No one has all of the information. Some analysts have done a good job of laboriously drawing out some of the data, but their primary focus has been on the very largest producers. The big industry surveys usually fail because their "averages" are not representative, and the survey takers aren't close enough to the business to fully understand why.

**The Premium Story**

The hidden story is in the premium segment. We don't have all of the information we would like to have, but we do have a large database on the scores of premium winery clients we serve, information from

the several industry trade associations we work with and, in addition, we have studied and analyzed every piece of data from every other source we could find.

From these sources we have compiled a database of sales information for premium wineries comprising over 95% of the California premium wine industry. As a result of that work and from our experience as industry consultants, we have drawn some statistics and conclusions.

The most graphic summary of wine case sales we have seen is from Impact, the industry newsletter from M. Shanken Communications, Inc. Its five year chart of California wine sales (Chart I) shows that generic wine consumption declined at an average annual rate of 4% while varietal wines climbed at an 18% annual rate for the same period.

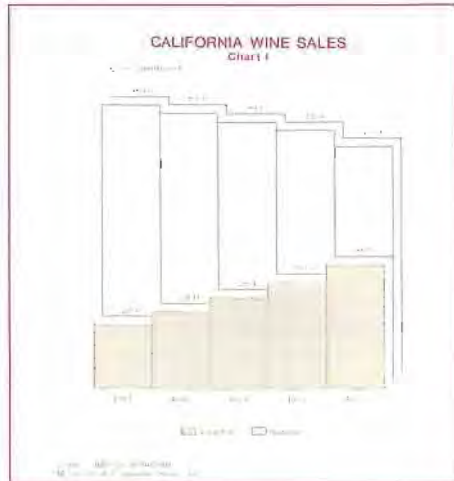
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WINE SALES

These trends are significant, particularly since they have been consistent over several years. They do not necessarily indicate future trends, but they do show a different picture than most recent headlines.

Our analysis of the premium segment shows that sales were up in every premium price category. There were many winners and losers in every winery size and price range, including many big winners and big losers. Winners outnumbered the losers by a ratio of 1.5 to 1. It is very clear from the statistics that wineries are trading customers, and the higher the price range the more this is true.

Large wineries were generally winners (Chart II). In fact, almost every winery over 500,000 cases was up. Most of the growth for these large wineries was in popular-priced premiums. Good quality, packaging and pricing backed by real marketing muscle and astute management made this group successful.



Many small wineries were losers. For some this was due to inventory shortages caused by a combination of market success and smaller crops in recent years. Others are losing to brands with stronger marketing. It's a real war zone for small brands with small marketing budgets. That is why many smaller wineries jointly marketing with others are winning. Among all wineries, the most visible aggressive marketers were up. It's easy to correlate visible brands and sales increases in the statistics.

There is a group of about a dozen 30,000 to 50,000 case wineries

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**FINANCIAL IMPACT OF THE PHYLLOXERA THREAT**



Mike Fisher

One hundred years ago when phylloxera first infested Napa Valley, vineyard acreage dropped from 20,000

to 3,000 and the fledging wine industry was devastated. Will history repeat itself or is the biotype B phylloxera just another one of Mother Nature's inconveniences? In the 1890's resistant root stock was a new concept and the wine industry in Napa Valley was not yet recognized as world class. Consequently, many of the vineyards were not replanted. In the 1990's, though it is unlikely that phylloxera will devastate the industry as it did a century ago, it will have a major financial impact on wine grape growing in the North Coast.

Based on rather conservative assumptions regarding the spread of phylloxera in Napa Valley over the next 10 years, we feel the financial impact could be as great as \$250 million. We estimate that over 13,000 acres of vineyard will be replanted in

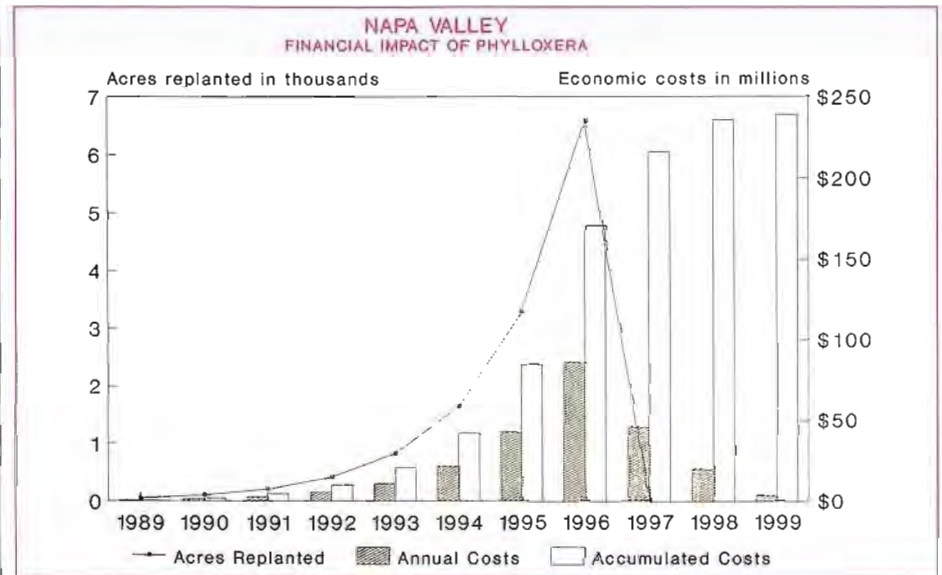
excess of normal replanting programs. The present value (10%) of this economic cost amounts to over \$57 million. This present value analysis assumes all vineyards will be replanted eventually and phylloxera will only mandate earlier replanting. We expect the impact on Sonoma County to be comparable to that in Napa Valley because of similar acreage and vineyard age.

There is a bright side to this major replanting which allows us to discount the impact somewhat:

- Because of increased technology in the last few years such as trellising, irrigation, vine spacing, etc. the overall yield in tons per acre could be expected to increase from less than four tons today (average of the last three vintages) to the range of 5 to 6 tons.
- Because of replanting, the grower has the option of budding a variety which yields a higher price such as Cabernet or Chardonnay. For example, in 1989, Cabernet and Chardonnay received an average price per ton of \$1,450 in Napa Valley while the average of other varieties excluding Cabernet and Chardonnay was \$860.

Our analysis is based on the following assumptions:

- Eighty percent of all acreage in Napa Valley is planted on AXR #1 root stock.
- Acreage is based on CDFA grape acreage report.
- Seventy-five percent of the acre-



## DEFERRED TAXES

## DEFERRING THE TAX ON GRAPE SALES



Karen Kryla

Delaying the collection of payments for grapes to the following taxable year—or even longer—is a method often

used by cash-basis growers to defer income tax. Growers on the cash method of accounting aren't required to pay tax on the grape payments until those payments are "received".

The key word is "received". According to the IRS, a grower can actually "receive" payment (and therefore be liable for the tax) prior to actually taking physical possession of the funds. The IRS has held that growers have constructively "received" payment in the following circumstances and were liable for tax

even though the funds had not been physically received:

- Funds were credited to the grower's account;
- Funds were set apart for the grower;
- Funds were available so that the grower could have drawn on them;
- Grower could have received the funds upon request;
- Grower received an obligation which could have been sold or assigned giving it a fair market value. The IRS deemed this to be a "cash-equivalent. Armed with the following, the cash-basis grower can defend the tax deferral position:
- Grower has a written contract with the winery.
- Contract is entered into *before* harvest.
- It is expressly stated as non-negotiable and not assignable.
- Contract sets forth the deferred payment schedule and does not provide for the grower to opt for payment at an earlier date.

When the vineyard and the winery are related parties, the above recommendations are even more critical in sustaining a tax-deferral position. ♦

## MONITOR YOUR SUCCESS



Debra S. Sasser

Great wine is the goal of all wine-makers. This goal is attained by the careful selection of

grapes and winemaking techniques and is followed by careful monitoring of the product throughout its development.

Financial success is the goal of all winery owners. This too, just as with the wine, must be approached by the careful selection of tools and methods, and the constant monitoring of the progress towards that goal.

Forecasts and budgets are financial planning tools. In a previous issue (March 1989) the MKF newsletter discussed the importance of forecasts for long-range planning. Forecasts represent management's estimate of expected results on an annual basis over five to ten years. But, when a forecast year is in process, how does management monitor its progress in achieving the goals set in the forecast?

An annual budget breaks down a forecast year into monthly segments, allowing management a tool to monitor whether the goals stated in the forecast are being achieved. Seasonal fluctuations are figured into an annual budget to take into account events such as:

- release dates and sales fluctuations
- promotional programs
- bottling costs
- grape payments and crush expenses
- periodic payments (i.e., insurance, interest, taxes, etc.)
- debt payments

By considering the timing of these fluctuations, cash flow needs can be estimated on a monthly basis.

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*Phylloxera continued*

age planted prior to 1980 and 10% of the acreage planted after 1980 is excluded from the phylloxera replanting because it would be expected to be replanted for other reasons.

- Acreage affected by phylloxera will double each year starting with 100 acres in 1989 so that all acreage will be replanted by 1997.
- Financial cost of replanting consists of development cost and loss of crop. This totals \$18,000 per acre and is based on the 1989 UC Extension study on vineyard establishment and farming costs and 1989 grape prices.
- Resistant root stocks will be available for all new planting.

With over 90 sightings in Napa Valley and 12 in Sonoma County, the presence of phylloxera is not an isolated incident. Though the threat appears to be real, its effect to date has been minimal, with approximately 100 acres removed. There has

been extensive use of the insecticide Furadan, which slows the spread but does not eliminate the pest. For obvious reasons, any new vineyards should be planted on resistant root stock and any movement of equipment or soil from an infected vineyard closely monitored.

Many growers have expressed concern that non-AXR #1 rootstocks may also be susceptible to phylloxera. Since AXR #1 parentage is 50% *vitis vinifera* (the species grafted to the top of the rootstock to produce our grapes and very susceptible to phylloxera) and all other available rootstocks contain no *vinifera* parentage the phylloxera problem is isolated to AXR #1.

There is little that can be done other than take this threat seriously and adjust long term planning accordingly. Availability of non-AXR #1 root stock could be a problem for the next few years, and the impact of this replanting will undoubtedly affect grape supply during the 90's. ♦

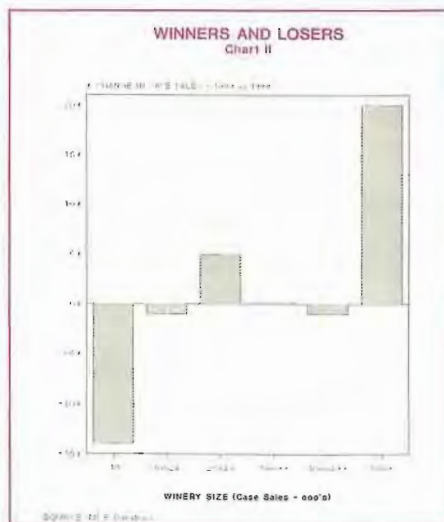
*Wine Sales continued*

which are having blazing success. They have it all: some of the best wines, top prices, image and reputation, critical acclaim, strong management and of course, high earnings.

Obviously, they don't read the headlines. Some of the wineries that were well-established in the 1970's have slipped a notch recently. Many of the second and third generation family wineries have also declined. No category however is without both winners and losers. And, the size of the gains and losses covers a wide range (Chart III).

**The Future**

The wine world is becoming more complicated and more competitive, but we are optimistic about the future for premium wine. Grape prices and demand for grapes are at an all-time high. Some of the smartest operators in the business have expansion or acquisition plans. The long-term viability of wine has improved over the centuries, and the short-term recent success provides encouragement.



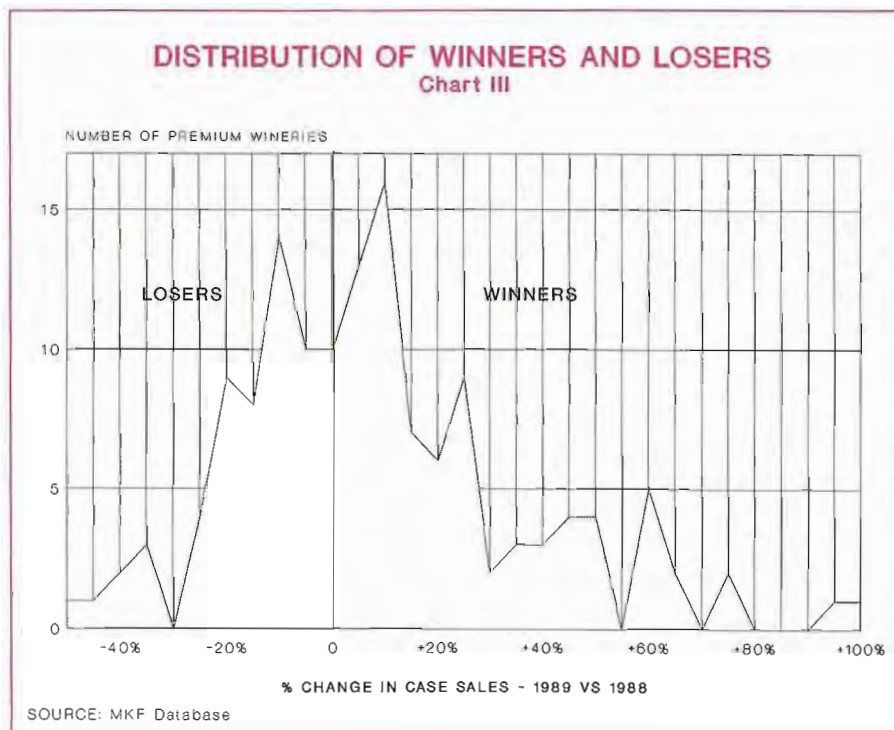
Winners will have to distinguish themselves in the marketplace and find new ways to reach consumers with a modern message. They will have to do this in an environment of continued marketing consolidation, particularly among larger producers with big marketing guns.

The industry *must* collectively find a way to expand the market base and to promote wine as an understandable, easy-to-enjoy product. ♦

*Monitor Your Success continued*

Once the budgets are developed, management needs a method to compare actual with these expected results. Preparing the budget and filing it away in a desk drawer won't accomplish this. The follow-through is more important than the preparation of the budget. Most computerized accounting programs offer the ability to generate reports comparing budget to actual. This is one feature of the Solomon III accounting software which MKF supports. Solomon allows for the entry of budget figures on a monthly basis and offers a great deal of flexibility in the design of reports to present that information in comparison to actual—by month, year, department, with dollar variances, percentage variances and more.

Effective management requires the timely output of such reports as well as a constant effort to address deviations from the budget. The preparation and monitoring of an annual budget is both a prompt for taking action when events do not conform to expectations and a tool to monitor success. ♦



**MKF WINE INDUSTRY SERVICES**

- Financial statements tailored for wineries and vineyards
  - Tax planning and preparation
- Winery and vineyard feasibility studies
  - Financial forecasting and long range planning
- Bank and financing proposals and negotiations
- Computer accounting systems installation and support
- Recruitment, training and support of accounting personnel
  - Review of winery and vineyard operations
  - Winery valuations
  - Litigation support

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