

MKFMOTTO, KRYLA & FISHER
Wine Industry
Accountants and Consultants**WINE INDUSTRY****UPDATE***"Wine industry financial, business and tax ideas."***PROFILE OF A PROFITABLE WINERY—
WHO ARE THE WINNERS?***Mike Fisher*

In the last issue of MKF Wine Industry Update, Vic Motto's article showed that sales of premium wines continue to increase in what appears on the surface to be a down wine market. What the statistics also show is that not all wineries are moving with the industry trend. The spread between the winners and losers is growing. Never before has the premium wine industry displayed a greater divergence.

Only two segments, based on winery size, show significant case sales gains from 1988 to 1989. These two segments are wineries selling in the mid-premium case range (25,000 to 50,000) and the large wineries selling over 500,000 cases.

In my March, 1990 article in the MKF Wine Industry Update I discussed marketing costs. An analysis prepared for that article included statistics on marketing costs and sales per case based on winery size. The mid-premiums had much higher sales (\$91) and moderate marketing costs (\$26) leaving a much greater spread between selling price and marketing costs than the other size wineries.

The trait consistent with successful wineries is effective marketing.

This data and our wine industry experience through working with over 75 winery clients lead us to the same conclusion: There is a plateau at the mid-premium level that makes a lot of sense. Whereas, for example, wineries operating at the mini-premium level (10,000 to 25,000 cases) seem to be in a "dead zone," with few profitable wineries.

By the analysis of cause and effect,



Dennis Groth of Groth Vineyards and Sandra MacIver of Matanzas Creek Winery discuss with Mike Fisher the keys to success in the premium wine business for the 1990's.

one would assume that mid-premium is the place to be. If you accept the fact that this is not just coincidence—and a number of our highly profitable clients fall into this range—one might try to look at this group and determine what traits they have in common. We see these similarities:

High Case Price

Obviously this is an easy one. The higher the price, the more money you make. Wine pricing is a completely separate issue and with higher prices, higher costs follow. But if you compete in the premium market at this level of production, low margins don't work.

An Established Recognizable Highly-Visible Brand

This may be a chicken and egg analysis. All the winners fall into this category though. For whatever

reasons, the brand has gotten there and is recognized by many consumers, not only in California but also in Kansas City and Cleveland.

Major Emphasis on Top Varieties

This principally consists of Chardonnay, and Cabernet but includes Pinot Noir. Other varieties do not allow the winery to achieve higher prices (how many \$15 Sauvignon Blancs do you see?). This doesn't mean that the wineries should not produce other varieties, but just that their marketing emphasis should not be centered on them.

Promotion Targeted to Consumers Rather Than Wholesalers or the Trade

A bottle of wine is not truly sold until it is consumed. At high prices, premium wine must be "hand sold." This type of approach emphasizes

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HOW TO BORROW MONEY



Vic Motto

Bankers, even those who market aggressively, play by some pretty conservative rules. They may pursue you,

admire your ideas, and then turn down your loan. But in fact, banks do want to lend money. It is their main business, and wineries and vineyards can be some of their most attractive customers.

Lenders, however, are in a tough game with only one way to win and many ways to lose. The very best they can do is to get back their money plus interest. While they have no chance to make an extra profit, they can lose up to 100%.

The 1970's were the euphoric years for the wine industry. Every winery had great potential and credit was relatively easy. Reality set in during the 1980's as marketing became more difficult with many new and complex issues facing the wine industry. In other areas, agriculture was a source of substantial loan losses. Lenders began to take more of a business approach, and now they insist that borrowers do the same.

The key to borrowing money today is to understand what lenders want. A lender's short list has only four criteria:

- A knowledgeable borrower;
- Adequate collateral;
- A good track record;
- A fallback plan.

Loans are most often turned down for failing one of these tests. A surprising number of borrowers do not understand the underlying fundamentals.

A knowledgeable borrower should know how much money he needs. Sounds simple, but you must know

how much you need now as well as later. Neither is necessarily easy to determine. Often, borrowers don't do the planning needed to answer these questions. For example, many wineries don't realize that over time they will need to invest as much or more in building inventory as they invest in their entire winery facility. Also, they may not have projected how much their total operating losses will be until a profitable point is reached. Many lenders, however, do understand these areas and won't favorably view a borrower who hasn't dealt with them.

Adequate collateral means not only sufficient collateral, but that the assets you finance must match the loan. Collateral must last at least as long as the loan period and ideally, the collateral will generate the funds to repay the loan.

A good track record means that at a minimum you have the background and expertise to make a profit and repay the loan. It also means that you have established some record of generating cash flow. If you have a long track record of positive cash flow, you are in the best position as a prospective borrower. If not, you may be able to show that you have established a market and a price level for your wine which is greater than prior years, and which will generate positive cash. Or, you may be able to show that you are about to exceed the break-even point due to economies of scale with expenses or by reaching equilibrium of production and sales. These approaches require the artful blending of an analysis of prior years' results with some well thought-out financial forecasts.

If you don't have a solid track record, then a fallback plan is critical. Optimistic projections alone won't suffice. Be prepared to give the lender another way out. The bank may want some assurance that if the first way (the business plan) doesn't work, a second way is available. This may be from substantial additional collateral, an outside source of cash, or well-backed personal guarantees.

Financial proposals and projections must be complete, well-documented, and above all, realistic. Many lenders know the wine business well. They will suspect that you don't if you are not realistic in your proposals. You are expected to have a complete plan, including how the bank will be repaid, backed by all of the requisite financial data. Anything less will put you in the amateur league. In short, be prepared. ♦

LEGISLATIVE UPDATE

Increase in Wine Tax

The wine industry is being attacked on both the federal and state front with increased wine taxes. A recent proposal in Congress has been made to increase federal excise tax on wine from 43 cents to \$9 per case. On the state level Proposition 134 would increase state tax from 2 cents to \$3 per case. An alternative initiative, Proposition 126 would increase state wine tax to 50 cents per case. The proposition receiving the largest number of votes will be adopted. We don't need to explain the effect of a \$1 per bottle wine tax on the wine industry.

Pesticide Restrictions

Two more propositions are listed on the California ballot, which would restrict pesticide use in the vineyard. "Big Green" (Proposition 128) eliminates the use of many commonly used pesticides in the vineyard, including sulfur, even though it is approved for organic farming. This initiative includes many other items unrelated to agriculture and is felt by many to be poorly written. The alternative initiative "Careful" (Proposition 135) is much less restrictive but sets up a state committee to assess the impact of various pesticides and establish tolerance levels. As in the wine tax initiatives, the winner takes all.

PHYLLOXERA

REDUCING THE FINANCIAL IMPACT OF PHYLLOXERA



Karen Kryla

Phylloxera. The mere word brings chills deep into the bones of any grower with vines on AXR #1 rootstock or their own roots. Not only does it conjure thoughts of large amounts of work to replace these vines, but also raises concerns about the sizeable economic investment needed. Vineyard development is a very expensive proposition. The 1986 Tax Reform Act has generally not helped the farmer in assisting with "tax benefits" to help mitigate these costs.

Prior to 1986, growers were allowed to take a 10% tax credit on the vines, stakes, trellis, irrigation systems, pumps, etc. and were allowed to deduct currently the cultural costs and interest costs connected with new vineyard development. Cultural costs such as hand vine care, pruning, cultivation and pest management were deductible when they were paid regardless of the maturity of the vineyard. Addi-

tionally, interest incurred on debt to finance this development was currently deductible.

Congress dramatically rewrote these rules for new vineyard development after 1986. The 10% tax credit is no longer available, and taxpayers are generally required to defer deducting the cultural costs and interest on debt incurred for the new planting until after the vines yield their first commercial crop. These accumulated costs can only be written off through the depreciation of the vine over its assigned ten-year life, and the depreciation doesn't even begin until the vine is producing! This can mean sizeable dollars going out the door in the early years without receiving any tax benefit until several years later.

The grower is hit with cash outflow for the actual cost of the vineyard development, reduced cash inflow due to lack of grape revenue and no current tax reduction for the tremendous amount of dollars being spent.

There is, however, a ray of sunshine to be found in the new rules. Congress provided an exception to the requirement to defer deductions related to new vineyard plantings when those plantings are in conjunction with a loss occurring due to disease, pest or casualty. Cultural costs and interest incurred on financing debt to replant vineyards damaged by Phylloxera, nematodes,

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HOW CLOSE IS TOO CLOSE?



Judy L. Skram

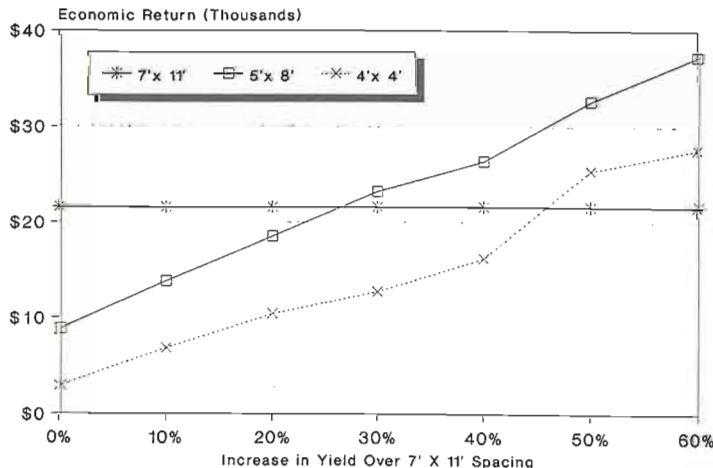
Thoughts have changed significantly over the last ten years with regard to vineyard spacing. Vineyards in California

have gone from the standard 8' x 12' (vine x row) to as close as 4' x 4'. Frequently we are asked our opinion regarding closer spacing, so we decided to run some numbers in order to evaluate the financial impact of different vineyard spacing options. Not surprisingly, we found that vineyards with closer spacing are more expensive. It requires a higher initial cost for vineyard development (vines, trellis, etc.) and also higher operating costs (labor, supplies, interest, etc.). However, we also found that the overall economics of closer spacing can be attractive depending on what assumptions are made as to vineyard yield.

While we can be reasonably comfortable with our cost assumptions, vineyard yields are much more subjective. In Winkler's *General Viticulture* he addressed the question of vineyard spacing and concluded that wider spacing was better. His reasoning was based on the premise that wider spacing lowered development and cultural costs with, up to a point, no noticeable loss in total yield after the vineyard was mature. While recognizing that close spacing resulted in accelerated yield during the development stage, increased competition among the vines at full production caused the yields to equalize, independent of spacing. The initially higher yields were not sufficient to compensate for the higher development costs. However, it is clear that Winkler's findings did not take into account the technological advancements made in recent years which allow us to suc-

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VINE SPACING COMPARATIVE CASH FLOWS



Profile continued

public relations and courting our good friends in the wine press. Receiving good wine reviews is critical. The wines must be pulled through the system.

Consistency of Wine Style and Story

Making the same varieties in the same style year after year goes hand in hand with telling a consistent story. You don't want to be a producer of malolactic barrel fermented Chardonnay one year and produce a stainless steel fermented one the next year. Obviously grape source also has a big influence on this trait. Maybe that is why wineries are buying vineyards these days. Also, if the winery's image is based on the owner's personality, he or she needs to be promoting the label consistently year after year.

The Ability to Spend Substantially on Sales and Marketing

There seems to be a threshold level of spending that any winery in national distribution must exceed before its wine sells well. This threshold level seems to be at \$500,000 and in many instances can be quite higher than that. Without the 25,000 case plus volume, this level of absolute dollars is difficult. Many wineries are attempting to reduce this threshold by joining together in marketing co-ops.

Efficient Production Facility

Few of the winners have elaborate and expensive facilities. Most are practical but attractive. Many were designed by production people and are laid out with production in mind.

Innovative Marketing

Quite simply, the winners have the ability to be the first to take advantage of trends in consumer promotion. This might be promoting wine by the glass or producing a small quantity of a unique wine which enhances the image of the winery's main products. Or it may mean noticing a trend in consumer purchasing of high end products at chain stores and having the ability to get shelf space before others notice the trend.

Effective Marketing Costs

Anyone can spend \$500,000, but

not everyone is successful. The winner is able to assess where marketing dollars are spent, measure the effectiveness and make changes when one area is no longer effective. Does media advertising pay for itself? Does one geographic region respond better than another to specific promotions?

The obvious once again comes through: the trait consistent with successful wineries is effective marketing. As we go into the 90's, with all of the obstacles that face the industry and the multitude of labels, not all wineries will be winners. However, our analysis concludes that those wineries with the above traits run a greater chance of being the ones that survive and succeed. ♦

Phylloxera continued

Eutypa, fan leaf and leaf roll viruses, Pierce's disease, winter kill, etc. can be deducted when they are paid. This can significantly improve after-tax cash flow just when it is most needed.

Growers wishing to take advantage of this current write-off should make sure they obtain a written, professional, third-party opinion concerning the presence of the damage prior to removing the vineyard to establish their qualification for the exception. ♦

Too Close continued

cessfully manage vine growth to achieve higher yields with greater density.

We created a model for a hypothetical vineyard and compared the economic return for that vineyard over its twenty year life, assuming the vineyard had been planted with 7' x 11' (565 vines/acre), 5' x 8' (1,088 vines/acre) and 4' x 4' (2,720 vines/acre) spacing. We assumed that closely spaced vineyards would show rapid increases in yield in the early years and would level off, but remain proportionately higher at full production than with wider spacing vineyards, despite increased competition for water, nutrients and sunlight. Our cost statistics for the 7' x 11' spaced vineyard are based on the 1989 University of California Cooperative Extension study for Napa Valley. While some costs remain the same regardless of spac-

ing, others, such as some development and farming costs, increase to a varying degree, in proportion to vine density. These increases are included with our assumptions.

We ran the model several times, varying our yield assumptions. The results are summarized in the graph. If you assume that long term vineyard yield can be increased by closer spacing, the additional cash flows from higher tonnage soon overtake the higher development and operating costs. Bottom line, you need 26% and 45% increases in yield to offset the additional development and operating costs for the 5' x 8' and 4' x 4' spacing, respectively.

There are various cautions to be applied in using this evaluation. First, spacing must be matched to soil type. Close spacing of high vigor varieties in fertile soil will give you nothing but headaches. In addition, the effect of close spacing on grape quality is still inconclusive. However, after giving consideration to these issues, closer spacing can potentially make a significant increase in your profits from the vineyard. ♦

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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