

M·K·FMOTTO, KRYLA & FISHER
Wine Industry
Accountants and Consultants**WINE INDUSTRY****UPDATE***"Wine industry financial, business and tax ideas."***MARKETING WINE IN THE 1990's***Vic Motto*

The challenges facing wine marketers today are enormous. Marketing wine takes time, imagination, perseverance and money. Wine is not a major consumer product. It's highly regulated. Marketing costs are high. These factors contribute to the lack of market information and the inefficiency of communication with the market. Success goes to those who can be effective in an inefficient environment. To be effective, a winery must understand its customers and communicate with them.

The marketplace for wine is changing. We're faced with declining wine consumption and conflicting health and social messages. More and more brands, distributor consolidations, battles for shelf space, and retail consolidations are making it harder to reach the market. The current climate should give most wineries sufficient reason for turnaround thinking.

"Marketing in the 1990's must change . . . You can start by establishing direct relationships with your customers, and by orienting your marketing strategies to that end."

Marketing in the 1990's must change. We must reshape the familiar approaches to marketing to deal with the new reality. A fundamental change in thinking is needed. To sell your product, you can no longer rely primarily on others. Distributors and brokers are fighting for their lives. You must fight for yours. The fight should begin by meeting the marketplace directly. You can start



Vic and Leslie Motto survey the wine market.

by establishing direct relationships with your customers, and by orienting your marketing strategies to that end. Cultivating customers directly has some immediate benefits and substantial long-term advantages.

First, who are your customers? In the wine business it is everyone in the distribution chain: wholesalers, trade and consumers. As a result, you must sell each case three times. You cannot afford to have a weak link in the chain. Everyone who makes a decision about your wine is critical to the process.

Creating a direct relationship with your customers must be in the forefront of your thinking. The higher priced your products are, the more direct that relationship must be. Getting a desired response from the right people is more important than entertaining all the people. Image awareness, creative product

positioning and personality are all important. But today's market also demands interaction and communication with customers. That communication must be creatively devised to identify, contact and cultivate your most promising prospects.

The key is for you to know your customers and use highly targeted messages and promotions to build relationships with them. How do you do this and continue to compete in today's tough marketplace?

Many distributors and brokers have convinced their winery suppliers that pricing programs are the key to sales. However, when sales become dependent on programming, the programs become counterproductive; merely producing temporary unprofitable sales. Unprofitable for the winery that is, and often not temporary. The alter-

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VINEYARD OWNERSHIP

THE WINERY DILEMMA—TO BUY GRAPES OR BUY VINEYARD?



Mike Fisher

Does it really make sense for a winery to own vineyards? It appears to, based on winery purchases in recent years.

However, with the cost of a developed vineyard in the range of \$40,000 to \$50,000 per acre the economics just don't pencil out. At current grape prices of \$1,500/ton for Cabernet and Chardonnay and average yields of 3½ tons per acre, the cost of purchased grapes is less than debt service on the vineyard, let alone farming and development costs and risk.

It is a tough call to commit capital to an investment which will have negative or low return for many years into the future. This capital might more wisely be invested in increased production capacity and inventory or increased marketing costs to develop and/or maintain the brand.

The issue obviously is much deeper than it appears on the surface, and as the premium wine industry matures we will see this anomaly continue, with winery ownership of vineyards increasing. Wineries control approximately 67% of vineyard acreage in Napa Valley and 55% in Sonoma County. Some say the percentage in Napa Valley has increased from 50% in 1980. Why has this trend occurred and why will we see it continuing?

• Capital preservation

Many investors feel very comfortable owning real estate. In farming, a large component of a crop's value is related to capital which is required to purchase real estate. As the general price level increases the crop value increases in greater absolute

dollars than farming costs, and capital costs generally remain the same. For example, if a developed vineyard costs \$50,000 per acre and prices and costs double, this occurs:

	Current Price Level	Prices Double
Tons per acre	3½	3½
Value per ton	\$ 1,500	\$ 3,000
Crop value	5,250	10,500
Capital cost @ 12% × \$50,000	(6,000)	(6,000)
Farming	(2,000)	(4,000)
Income (loss)	<u>\$(2,750)</u>	<u>\$ 500</u>

The effect of this escalation at various levels is shown on the graph. Not only does the economics change but should the winery decide to sell the vineyard at the increased value of \$100,000 per acre they would realize a \$50,000 gain. Grape growing becomes profitable and value of the asset increases. Of course, this only works during an inflationary period.

• Consistent grape source

Wineries which will succeed in the 90's will be those which have a consistent story to tell and make a wine which is consistent from vintage to vintage. Grape source is the

most critical component of this consistency.

• More control from vineyard to the bottle

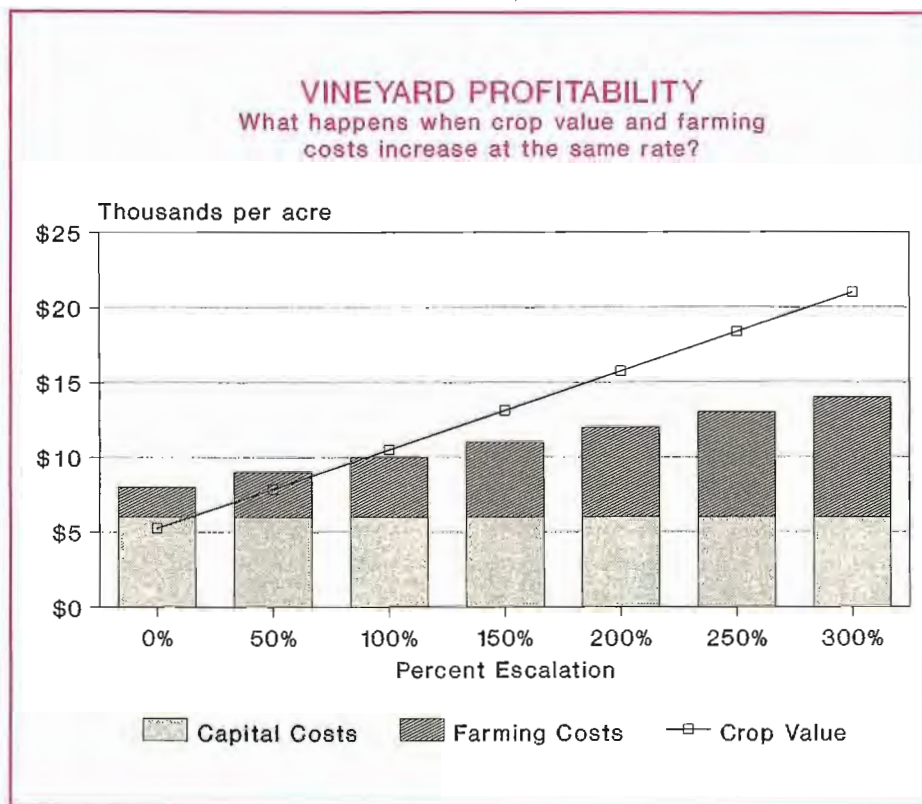
Obviously when a winery owns a vineyard they make all the decisions regarding its development and operations. They are not compromised when it comes to development decisions, crop level, canopy management, pesticide use or other cultural practices.

• The vertically integrated winery concept

Maybe this is more self preservation than economics but the integrated winery that controls as much as possible through the production process (Why does Gallo manufacture their own glass? Can they really do it more efficiently than Owens Illinois?) is better able to control its own destiny even though it may mean lower profitability.

Even with these reasons for vineyard ownership it may not be appropriate for all wineries. The winery must be mature or maturing and have a low debt level or owners willing to contribute additional

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BUYING A NEW VINEYARD? . . .



Karen Kryla

Don't miss the opportunity to accelerate the write-off of the purchase price.

The acquisition cost of assets lasting more than one year is written off via deductions spread out over a period of years. The annual deduction, known as depreciation, is set by the IRS and is determined based on the type and use of asset purchased.

Vines, for example, are currently written off evenly over a period of ten years; whereas, stakes, trellising, drip irrigation, and most other vineyard improvements are written off over a period of seven years with the largest deductions in the earlier years.

Buying a new vineyard? . . . Just buying vines and land? . . . Of course not, you're also buying all of those other vineyard improvements. You should position yourself to take advantage of the faster write-off that those improvements allow by allocating a portion of the purchase price to them.

Allocation of the purchase price among the assets purchased must be based on the relative fair market values of the assets acquired. The concept of fair market value often involves some degree of judgment and interpolation; and the IRS has been known to frequently have a different idea of fair market value than the taxpayer. It is important therefore for the taxpayer to be able to support any allocation claimed.

The best way to protect your claimed allocation is to get an appraisal breaking out the values of the various assets. Absent an appraisal, another good way to establish the allocation of the purchase price is to make the breakdown of the purchase price a part of the purchase contract.

The IRS is reluctant to challenge any reasonable allocation bargained for between two unrelated parties.

If you don't have an appraisal, and the purchase contract did not allocate the purchase price among the various assets, you need to come up with a methodology that you can explain and defend should the IRS ever challenge you.

The division of the dollars among the assets should be based on a rational methodology as opposed to a shoot from the hip approach.

The land cost needs to be separated from the cost of the vines and other improvements. The land cost will not be able to be written off until the property is sold, while the dollars allocated to the vines and other improvements can be deducted during your ownership of the vineyard through depreciation deductions.

One approach would be to determine the land value (by looking to recent sales of unimproved comparable properties) and then to allocate the remaining portion of the cost to the various depreciable assets. Another approach might be to look to costs of establishing the various depreciable components of the vineyards (perhaps using the UC Extension study "Sample Cost to Establish and Produce Wine Grapes in Napa Valley"), adjusting these figures for the age of the vineyard you are purchasing and then to allocate the remaining portion to land.

You might try both approaches and see which one yields you the more favorable result (i.e. more dollars assigned to depreciable assets).

The important thing to remember is to make an allocation of the purchase price among the assets you are purchasing (one that you can defend of course) so that you can take advantage of the faster write-off that some assets allow. Don't be stuck with your entire vineyard being depreciated over a ten year period!

P.S. A study is currently being conducted by the IRS to examine the asset lives for vines. The study has preliminarily concluded that vines have a 32-year useful life. The IRS will be using the results of this study for possible recommendation to Congress for future tax law changes

. . . read my lips. ♦

DO YOU HAVE A STRATEGIC PLAN?

Kathleen O'Dowd

How important is strategic planning? Strategic planning is analogous to deciding where you're going on vacation: until you've made up your mind where to go, you can't plan on how you're going to get there.

A clear strategic plan keeps everyone involved in your winery focused on "the right things." It's a pretty familiar scenario to see everyone trying to do things right (tactics) but because the tactics don't focus on strategy (doing the right things) they aren't getting the return they should from doing a good job.

What elements make up a clear strategic plan?

Mission Statement: How do you want your wine buying consumers, restaurants, brokers, distributors to identify you? You should be able to come up with a concise statement that everyone can focus on for planning, production, marketing, and promotion.

Environmental Analysis: What wineries are your competition for these wine buying consumers? Do you have a special group of consumers (restaurants, retailers, mailing list) you want to target? What do you need to do to remain competitive throughout the years?

Strengths and Limitations: What does your winery have that's special or different from your competition? What does it have that puts you on equal footing with your competition? What don't you have that puts you at a disadvantage with your competition or doesn't allow you to target your special consumer?

Basic Objectives: What's important to your winery? Organizational structure—is it responsive to the goals of your organization? Production—just how many cases do you have to produce to achieve your goals? What varieties do you want to be identified with? Marketing, sales and distribution—how are you going to let your consumer know

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Marketing Wine continued

native to excessive programming is to use the same marketing dollars to build direct long-term relationships with customers. This approach establishes your products at a more profitable price and uses your money to build your brand. Spending your marketing dollars on marketing instead of programming makes sense. You can use your money to create solid customers for your brand at profitable prices. The customer buys the brand instead of the price.

Establishing profitable prices is critical. Too often, wineries sell at low net prices with a plan to increase prices later, once the brand is established. Unfortunately, the brand becomes established at an unprofitable price level, and probably in a lower market segment. A price increase may then require a change in placements and customers. Establishing the price is so important that it must take precedence over volume. Volume is usually easier to change than price. No one knows how much you sell, but everyone knows the price.

Customer relations begins with your first customer, the distributor. Some wineries have comprehensive distributor support programs. They attend sales meetings, provide sales materials and incentives, train and work the street with sales reps. They establish relationships and communicate frequently. Other wineries have much more limited involvement and leave more to the distributor. It's clear who has the edge.

The second customer in the chain, the trade, must also be cultivated. If you do the cultivating, then you have the relationship. Otherwise, only the wholesaler does. The trade needs everything from you that the wholesaler needs plus everything that the consumer needs, so let's talk about the consumer.

How do you reach the consumer? This may be the biggest challenge. Because the consumer is hard to

reach, it is critical that the relationship be nurtured once established.

To reach the consumer, advertising is useful to build image and product-awareness. The newest trend in advertising is response advertising. Advertising that invites a response can serve two purposes. It can build awareness and image for the brand and it can create a two-way communication with customers. The information generated by response advertising can be added to your customer marketing database. In-store promotions can use the same principles as response advertising.

Once a customer connection has been made, there are many marketing options to build customer relationships. Direct mail, newsletters, educational programs, winery clubs and winery events are some of the options. These tools can be used in some very creative ways to communicate with customers.

The important principle in relationship marketing is to build a system of continuous direct communication with prospects and customers; one that shapes attitudes and produces sales. Wineries on the leading edge are bringing this approach to virtually every aspect of selling, from advertising to retaining customers. The 1990's will bring relationship marketing methods that no one has thought of yet. You can watch others or you can be a pacesetter. Start thinking now about how to systematically communicate with your customers, create customer loyalty and build a franchise for your brand. ♦

Winery Dilemma continued

capital. The winery should assess its long-term plan and determine if the additional capital might be better used to bring production and sales to an optimum capacity. Possibly the production facility would need upgrading or additional money should be spent to further develop the brand. Generally vineyard acquisition is not appropriate for a winery that is unprofitable.

With all this in mind, the most important intangible is the winery's overall commitment to the premium wine business and the expectation that the demand for premium wines will continue to increase and the consumer will pay a premium for these wines. ♦

Strategic Plan continued

about your product and then get it to them? Personnel—what kind of work environment do you need to attract the personnel you need to achieve your goals?

You should be able to summarize all of these elements into a brief basic strategy statement that defines who you are as a winery.

Remember you can make some tactical mistakes if your strategy is good. ♦

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