

MKFMOTTO, KRYLA & FISHER
Wine Industry
Accountants and Consultants**WINE INDUSTRY****UPDATE***"Wine industry financial, business and tax ideas."***THE FINANCIAL IMPACT OF PHYLLOXERA
— AN UPDATE***Mike Fisher*

How will biotype B Phylloxera affect our future? Like the current drought, this uncertainty makes it difficult for wineries to plan for grape supplies and for growers to plan for replanting capital needs.

From an article written last summer (July 1990) in *MKF Wine Industry Update* I concluded that the financial impact of Phylloxera in Napa Valley for the 1990's could be as great as \$250 million along with a similar impact in Sonoma County. My key assumption was that vineyard removals would double each year starting with a base of 100 acres in 1989. Industry opinion varies from a substantially greater spread (e.g. four-fold increase each year) to minimal increases (e.g. a few hundred acres a year without a geometric progression).



Jim Wolpert, University of California Extension Viticulturist and Mike Fisher in the Davis lab at Wickson Hall.

***500 acres of infected vineyards
were removed in 1990.***

Ed Weber, Napa County Farm Advisor, estimates that 500 Phylloxera infected acres of Napa Valley vineyard were removed in 1990. Weber feels that many of these removals could have been delayed until 1991. Because of the impending recession (a possible drop in wine sales and lower demand for wine grapes) and the unknown effects of Proposition 128 (most vines were removed before the election and Proposition 128 may have affected pest control, fumigation, etc.), many people jumped the gun. Weber anticipates that Phylloxera removals will be in the range of 500 acres in 1991.

Many times when baffled by a problem like this, it helps to look at history to provide clues. From research done by historian William Heintz we are able to examine the spread of biotype A Phylloxera in Napa Valley 100 years ago. Heintz's research shows that Phylloxera was first identified in 1881, at which time 500 acres were removed, and removals remained at the rate of a few hundred a year until 1890. In 1890 there were 20,000 acres of vines in Napa Valley but during the next seven years all but 3,000 acres were removed due to Phylloxera. These remaining 3,000 acres were on resistant rootstock.

In comparing biotype A versus biotype B one would conclude the spread of type B in the 1990's to be faster

than type A 100 years ago. In recent bioassays the general conclusion is that growth of type B on AXR #1 is more vigorous than type A on *Vitis vinifera* (Cabernet Sauvignon). Another factor encouraging spread today is custom farming practices with frequent movement of equipment versus horse drawn plows and wagons of 100 years ago.

Obviously no one knows how rapidly Phylloxera will spread and there are many other variables such as drought, floods, environmental changes (pollution, global warming, etc.). Also a yet to be discovered control for Phylloxera would affect any prediction.

So much for the big picture. The

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THE NEW FRONTIER



Vic Motto

Over the past ten years, California exports have grown from 3 million to 9 million cases and they will double in the next ten years. Despite that explosive growth, exports still represent only 6% of California wine and less than one-half of one percent of the world wine market. In other words, almost 95% of California wine is sold domestically. Three-quarters of California wineries don't export at all.

The export business is small. And because it's small, right now is a good time to enter the market. It's easier to get attention while there are relatively few California brands in foreign markets. Early involvement can help you become established while the market is still young, and allow you to grow with it.

WHY EXPORT?

As California wine becomes more recognized and appreciated throughout the world, there is great potential for export growth. With currently favorable exchange rates, now is an opportune time to expand exports. Many importers and trade accounts in foreign countries would like to introduce some new wines. Their markets are becoming more open and they have a curiosity and an interest in California. Wine consumption is much higher abroad and they don't have much California wine, so there is great potential for growth.

Building an export market can help improve domestic results. Placements in key international hotels and restaurants are image builders. New wine writers can discover your world-class wines. An enhanced international reputation can help improve domestic prices and profitability. Best of all, exports can add new customers without sacrificing the domestic market.

HOW TO EXPORT

Before you export, it is crucial to

state clearly the specific goals of your export program. For example, is your goal to build image and awareness? If so, are you targeting foreign customers, or U.S. customers travelling abroad? Are you trying to build volume or increase prices? Perhaps you want to export simply because you like to travel. Any of these goals are legitimate, but it's important to identify your real goal. That will determine what you need to do and how you should do it.

Getting started in the export business is more a function of problem-solving than marketing. The first shipments to a new country can be very time-consuming and difficult. After that, it gets easier. The export program should be set up by someone in your organization who can patiently and tenaciously solve complex problems. The problems can be with setting up procedures and making arrangements for distribution, communication, licensing, packaging, shipping, credit, currency exchange, tariffs, insurance, government agencies, logistics, tracking and follow-up.

Marketing is a separate matter. The same fundamentals of marketing apply here as they do anywhere else. You need a well-defined strategy, sound distribution, good placements, and market support to build your brand.

If you are reasonably well established at home you should look abroad.

Your first shipment should be small, so it can lead to repeat business. If the first shipment is too large, you may not see or hear from the market for a long time. Obviously, one transaction, even a large one, will not make a market. Building an export market is a long-term process. Take it slowly to learn and refine the process. Even the great export successes have taken several years to become established.

What happens if you don't visit your domestic markets and don't stay in touch with your distributors? Nothing. The same is true for export

markets. Start by going there. Learn the market, visit the trade, talk to consumers. Talk to them about their preferences. Tell your story and teach them about your products. Work with the chefs and sommeliers, especially the younger ones who will influence the future. Invite them here to learn about our food and wine, and work with our restaurants who feature their cuisine. More work is needed to teach the export markets how to use our wines to complement our food as well as their food.

CONCLUSION

If you are reasonably well-established at home, you should look abroad. Exports can be an excellent way to expand your market and improve both your visibility and profitability. Start with research. Talk to other wineries and the industry organizations involved. This includes your regional trade association, Wine Institute, California Department of Food and Agriculture, the USDA Foreign Agricultural Service in Washington, D.C., and California Export Finance Office in San Francisco. They have many programs and resources including money to help you.

Financial Impact continued

important issue is how each individual grower will deal with this threat. What are the important issues to focus on and what strategy should the grower consider in planning for the 1990's? Replanting strategies fall into two basic approaches. There are many variations of these two methods.

- *Individual vine replacement or interplanting*

Individual vine replacement involves replanting vine-by-vine as the vines are killed by Phylloxera. Interplanting entails planting vines in healthy but susceptible vineyards at intervals between existing vine spacing within the row or between rows.

The principal advantage to these methods is that they allow the

grower to continue receiving a reduced crop because productive vines are not removed. Development costs are less because existing vineyard improvements (trellis system, irrigation, stakes, etc.) remain in use.

The key disadvantage of these methods is the inability to start fresh with new vine spacing, trellis systems, fumigation, etc. The success of interplanting is still unknown. Both methods leave vines of different age, making the farming process more expensive and difficult. Circumstances favoring these methods are young healthy vineyards, plenty of water, correct spacing and trellis system, and low to moderate vigor soils.

• *Complete removal of the infected vineyard on a block-by-block basis*

Once the grower detects Phylloxera and enough vines are infected to substantially reduce yields, all the vines of a block are removed allowing a standard replanting process. The advantages and disadvantages to this method are the reverse of those in the vine-vine replacement methods. This is a proven method and the results are predictable if done correctly.

We have analyzed the economic effect of these methods by preparing three financial models. These scenarios assume an infected fifty acre vineyard,

ten years old with standard 8'x12' spacing and single 2' cross-arms, yielding four tons per acre on moderate vigor soil. The new vineyard using current technology (scenario A and B) is a quadrilateral lyre trellis system with 6'x11' spacing yielding six tons per acre at maturity. Costs are based on the 1989 U.C. Extension study on vineyard establishment and farming costs and adjusted where applicable. There is no escalation of costs or grape prices (\$1,400/ton).

These scenarios are:

A. Removal of the entire fifty acres in 1991

B. Gradual removal of acreage

Year	Acres Removed
1991	10
1992	10
1993	15
1994	15
Acres	50

C. Replanting vine-by-vine with net replanting of

Year	Acres Removed
1991	3
1992	6
1993	11
1994	20
1995	10
Acres	50

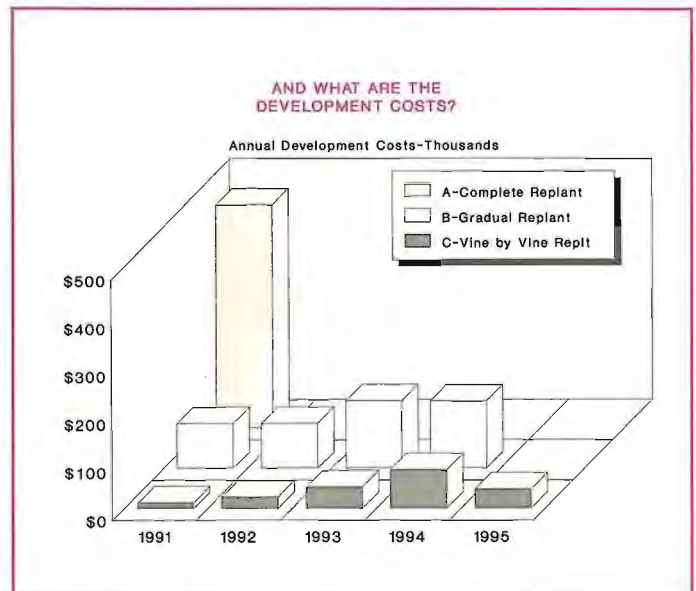
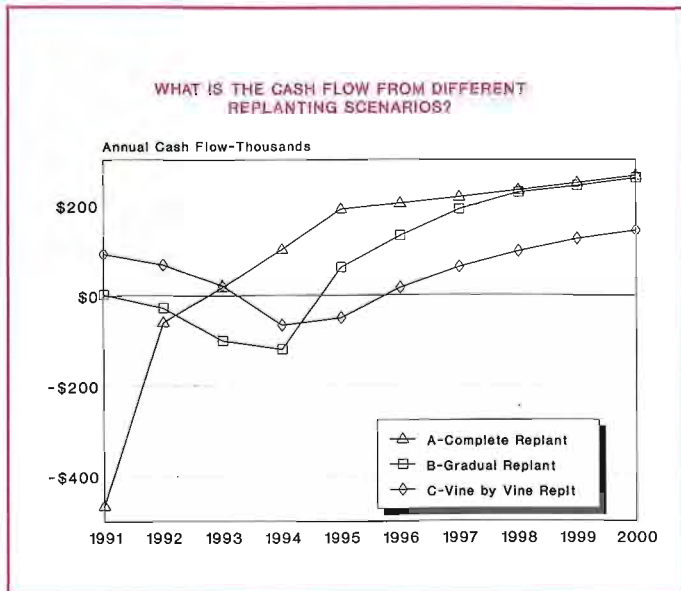
C. *continued*

Yield remains at four tons per acre after replanting and the new vines require six years to reach full production (vs five for scenario A and B) because of greater competition and difficult farming.

Of these three principal strategies for replanting, which should be used? The results of the models favor scenario B — gradual removal of blocks. The cash flow analysis includes everything — development costs, crop value, farming, interest, and income taxes. When the present value (10%) of this cash flow is calculated through 2010 scenario A would return only 91% as much as B, while C would return only 66% as much as B.

Our analysis assumes correct rootstock will be available for this anticipated planting. In statistics put together by nurseryman Rich Kunde of Sonoma Grapevines there appears to be sufficient acreage of mother blocks of the most popular rootstocks. Assuming a 7'x11' spacing, sufficient quantities are available of the most popular rootstock (039-16, 3309, 110R, and 5C/SO4) to plant in excess of 20,000 acres annually. Because of greater demand these mother blocks will undoubtedly be increased over the next few years.

The anxiety and reality of Phylloxera will affect us all over the next decade but proper planning by the grower will reduce its impact. ♦



FEDERAL WINE TAXES — WHAT'S NEXT?



Karen Kryla

Just when you thought you must be safe from more wine taxes — out comes another tax increase.

Remember the California Proposition 134 and industry-supported Proposition 126 — both defeated? Despite the electorate's wish for no new taxes, two identical bills have been introduced in the Senate which would increase the California wine tax from its present 1 cent to 19 cents/gallon. Pooch Pucilowski, Principal Consultant to the Assembly Select Committee on California Wine Production and Economy feels neither of these bills will pass. However, he does foresee a 20 cent/gallon tax being a part of a larger "package bill" coming from the Governor and the leadership of the Assembly and Senate. There are discussions concerning the possible inclusion of an exemption for small wineries similar to Federal law; however, the two Senate bills do not contain this exemption.

Also in line for a bite out of your profit is the cost of your wine bond. The wine bond is required to cover the "unpaid" excise tax on any wines in bonded areas. The "unpaid" tax is computed using the statutory rate (\$1.07) regardless of whether you are eligible for a lesser rate using the small producer's exemption. The BATF indicates that this was an "oversight" and that they will be drawing up a "technical correction bill." In the interim however, your bond coverage must be computed using the \$1.07 rate. If you are found to be short on the amount of your bond, the BATF will simply request a strengthening bond and impose no penalties.

As most of you are aware, a technical glitch in the new Federal excise tax law is causing wineries who ship

WINERY CASH FLOW VERSUS PROFITABILITY



Debra S. Sasser

INCOME TAXES AND NO CASH! Why? When you have to pay taxes it means you've

made money, but you may not have the cash available to pay the taxes.

- If production is increasing, cash has to be spent for the additional grapes and supplies. This might also require extra payroll and facility space.
- Changing product mix to more red wines with longer production cycles, creates the need to pur-

chase additional barrels for the overlapping of vintages.

- As grape prices and other costs increase, more cash is needed to make the same wine.

Not only do the above situations take extra cash, they can't be deducted until another time.

There are other circumstances that can create a cash shortage, when the winery is profitable. Paying down debt takes cash from profits. So does taking cash out of the winery to buy personal assets, like a residence. Or, you may have sold a lot of wine, but you haven't received the cash for it yet.

A premium winery is one of the hardest businesses to run by the check book. Understanding the differences between cash flow and profitability is critical to a winery's success. ♦

from warehouses to lose their small producer's exemption. It was originally hoped that the BATF would draft regulations to remedy this situation. Unfortunately, the BATF does not feel they have been given the legislative authority to draft these regulations but will support technical correction legislation. John Hinman, counsel for a group of warehouses and wineries who have formed a "technical corrections committee," is hopeful that laws and BATF procedures can be instituted to shift the tax payment liability back to the winery when the wine leaves the warehouse without the wine itself having to make the trip. This "technical corrections committee" has been collecting input from interested parties and hopes to submit suggested procedures to the BATF during February. How long this might take to translate into enacted legislation is unknown, particularly in view of other world affairs facing Washington today. I'll keep you posted. For the interim, to receive your small producer's exemption, it appears best to pay the tax when shipping wine to the warehouse. ♦

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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