

MKFMOTTO, KRYLA & FISHER
Wine Industry
Accountants and Consultants**WINE INDUSTRY****UPDATE***"Wine industry financial, business and tax ideas."***DO WINERIES MAKE MONEY?***Vic Motto*

A common question in our business is, "Do wineries make money?" The short answer is "Yes, but . . ."

WINE INDUSTRY RESULTS

Each year, one or another of the giant international accounting firms does a "wine industry survey". The most recent version concludes that industry profitability has been declining for several years, and that average wine prices have stabilized. These industry-wide statistics however, are very wide indeed. The results are skewed by the large wineries operating in the lower price segments. These big surveys also don't adequately consider many unique wine industry factors, for example, the influence of brand maturity on winery profitability.

**PREMIUM WINERY RESULTS**

To develop a more specific answer for the premium sector, we studied the results of over eighty premium wineries served by MKF. This group is an excellent cross-section of the top segments in the industry. It includes everything from big winners to struggling young brands. We did exclude all brands with less than five years in the marketplace, since virtually all new brands experience losses for several years. New brands often spend more per case to sell wine than their cost to produce it. Administrative and financing expenses further increase start-up losses. We also excluded wineries with average F.O.B.'s of less than \$50. Segments below this price have very different business characteristics and results.

The results of our study group are shown in the chart (see back page). Two-thirds of the wineries with over five years in the market are profitable. The majority of these are becoming

even more profitable. Most of the wineries in the group are increasing sales volume and improving prices. These trends are very positive, and they show some real strength.

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The best in the group are doing very well indeed. The most outstanding example is a winery of over 50,000 cases, with \$8 million in sales and a pre-tax bottom line of over \$5 million or, over 60% pre-tax return on sales. This extraordinary success is certainly not typical, but it is encouraging.

WHO IS SUCCEEDING?

In the current recession, winery results vary considerably, and the

range has widened recently. Sales patterns have become erratic as distributors and trade bounce from pushing one brand to another. These patterns can make it difficult to read profit trends.

Clearly, the profit battle is being fought in the marketplace. Winners generally have concentrated in a single price segment, and have invested to establish a good base in each individual market and sector. They also understand how their products must be priced to compete effectively for image and profitability in their segment. In short, they know their segment, and have price, volume and marketing in balance. While other industries are "downsizing" to revitalize their bottom lines, wineries are becoming more market-driven . . . working harder and smarter to establish

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TAX TIPS

Karen Kryla

• DON'T WAIT UNTIL YOUR VINEYARD OR WINERY HAS "SIGNIFICANT" ACTIVITY TO ADDRESS HOW YOU WILL TREAT ITEMS FOR TAX PURPOSES.

Any activity at all, even the most trivial, may lock you into tax elections by default without the ability to consciously consider the alternatives.

Many elections must be made in the first year that an activity occurs or a "default election" kicks in. Default elections are usually the ones the IRS would pick given the choice. Examples of a few of the activities that must be considered in the early-going:

- *organizational structure*
- *fiscal year*
- *choice of accounting methods (cash, accrual)*
- *adoption of inventory costing methods*
- *soil and water conservation expenditures*
- *vineyard preproductive farming costs*
- *label design costs*

• DOCUMENT TRANSACTIONS BETWEEN YOUR VARIOUS CONTROLLED OPERATIONS IN THE SAME MANNER THAT YOU WOULD WITH AN OUTSIDER.

The IRS is ever watchful for related-party transactions. These transactions, because of their lack of arms-length in fact, are closely scrutinized. The IRS will be looking at the terms and treatment in each of the related tax returns.

These transactions may include:

- *Vineyards selling grapes to the winery.*
Do you have an invoice from the vineyard to the winery and a grape sales contract entered into before harvest?
- *Funds loaned to or expenses paid for another entity.*
Is there an executed promissory note evidencing the repayment terms and bearing interest with at least the IRS prescribed minimum rates? Interest-free loans are no longer allowed by the IRS.
- *Custom farming performed by one entity for another.*
Is there an executed contract setting forth the job to be performed and the rate to be charged?
- *Properties owned by one entity and used by another.*
Is there a rental contract?

Yes, it seems like a lot of work, but better to have the transactions structured the way you want them rather than the IRS' way.
- **REVIEW YOUR ARRANGEMENTS WITH YOUR SERVICE-PROVIDERS.**

The IRS has recently joined efforts with the California Employment Development Department to "root out" those relationships that are currently being treated as contract work which, in the taxing authorities' opinion, should be treated as an employer-employee relationship. This will be a hot item this year. Relationships treated in the past as independent contractors may not pass the closer-look that they will receive in the coming months. Failing to pass the test may leave you as the "employer" with sizable back payments to be made for FICA and taxes not withheld from your "employees" . . . not to mention the penalties and interest that would be assessed. ♦

DISTRIBUTING PREMIUM WINES — IT'S NOT GETTING ANY EASIER



Mike Fisher

The key to successfully marketing any product is to create consumer demand and effectively distribute the

product to the consumer. Distribution of premium wines operates under a complicated system. In most cases three tiers are used, and in some cases four tiers, meaning a lot of middle men.

Not only is the system complicated, it is constantly changing. Change is due to many reasons, including distributor consolidations and consumer trends towards chain stores and discounters. Within this complicated moving target there are still a number of options available to the premium winery.

The California market is wide open, i.e. a winery may sell at any tier; however, out of state sales generally require a local distributor or agent. An example of the cost relating to each tier is shown on the graph. Sales to each tier have advantages and disadvantages:

• *National Distributor*

This is an arrangement wherein the winery contracts with a national distributor to purchase all production. These arrangements either work very well or not at all; there seems to be no middle ground. The net cost to the winery ranges from 10% to 20% of the standard FOB distributor price. In most instances the national distributor pays many of the marketing costs.

A major disadvantage of this arrangement is that the winery relinquishes control over pricing and production quantities. If the national distributor is unable to sell the quantities of wine produced for whatever reason, they may reduce the price and/or quantity of wine they purchase. This leaves the winery with either excess inventory or capacity without the revenue to cover costs. Also the winery may be unable to legally sell the wine due to the exclusive distribution contract.

Other problems relate to brand development costs. A national distributor may not be willing to make the major financial commitment to building a winery's brand. No matter how long or solid a contract, wineries do change distributors. When a change occurs, the winery may have to create a marketing program and national distribution from scratch. Also, if the relationship is terminated the national distributor may have large quantities of wine in inventory, and may "dump" the wine on the market at low prices. This is what a group of plaintiff wineries are contending in a current lawsuit against a national distributor.

Even with all the negatives pointed out above, there are circumstances where the national distributor relationship works well. In these instances, the winery stays actively involved in promoting its wines and building and maintaining the brand. These wineries have strong relationships, not only with distributors, but with the trade and wine press and are highly visible with consumers.

• *Distributor Direct*

A majority of the premium wineries employ this method. The winery deals directly with various distributors. It is not unusual for a winery of national distribution to sell to 50 to 75 different distributors.

The big change in this area, which has been occurring in the last few years, is distributor consolidation. Ten years ago there were smaller distributors handling certain geographic areas within California or other states. Today two major state-wide California distributors, Young's Market and Southern Wines and Spirits, are dominant. There are other second level distributors which are state-wide but much stronger in one region versus another, such as Wine Warehouse in Southern California and Vintage House in Northern California.

These state-wide distributors may require an exclusive state-wide contract, i.e. it's all or nothing. With a state-wide distributor you may be one of scores (possibly hundreds) of other wineries in the "book", which makes it difficult for the distributor to effectively promote your brand. In effect the distributor is acting as an order taker and delivery service, at which they can be very effective. This may allow for future opportunities for the "guerrilla" distributor to fill the open

ground and specialize, on a regional basis, in selling premium wine only.

• *California Wholesale*

The winery sells direct to the trade (retailers and restaurateurs). Of course the wine is sold delivered and most orders are in small quantities (five to ten cases). In effect the winery is acting as its own distributor. Many wineries employ brokers to sell and take orders, with the winery responsible for delivering, invoicing, and collecting for the wine. Other wineries deal directly with the trade without brokers. In some instances wineries will use a distributor for a specific region in California and sell direct in other parts of the state.

Determining whether to use brokers is a tough call. You pay a broker based on what they sell (12%-20%). If you hire a full-time winery representative you pay whether he or she sells or not (less any incentive bonus, etc.). For a winery representative to make sense, he or she needs to generate \$350,000 to \$500,000 in annual sales. The winery representative gives you more control than the broker who also sells for other wineries. If demand is strong enough, neither a representative nor broker may be needed.

Matching your winery to the broker can be critical to a successful relationship. For example, if your marketing plan involves selling extensively to restaurants don't hire a broker who is strong in retail shops or grocery stores. Does your brand fit with the other wineries the broker represents such as those which specialize in expensive cabernets or those who offer a full compliment of wines through a diversity of appellation, varieties and style?

California wholesale makes the most sense for the winery with a

strong and established brand so the trade is willing to put up with the inconveniences (separate orders, deliveries, etc.). The higher price level allows the winery to be more involved and have more control over marketing. For a 30,000 case/year winery with \$3 million in sales, selling 40% of its wine in California under the standard pricing structure, this means an additional \$300,000 available to spend on marketing or, for those lucky enough, drop more to the bottom line.

This method was most common in the 1970's and early 1980's, but in many cases it still makes sense.

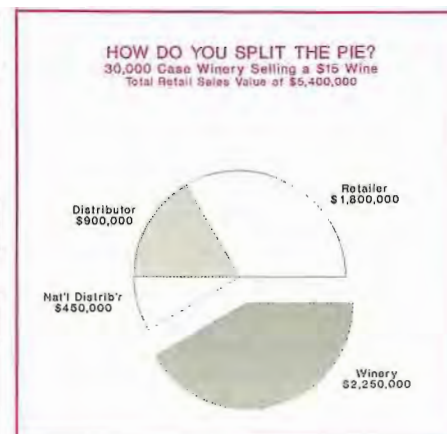
• *Consumer Direct*

This can be done in two ways, tasting room or mailing list. The tasting room is a function of location, some good examples of strong tasting room sales are Viansa and V. Sattui wineries. Many wineries have tasting rooms but most of these do not exceed 10% of total sales.

Mailing list sales are successfully used by some wineries but require lots of effort and patience and a number of years to develop. The concept is straight-forward but the keys to success are:

- 1) Exclusive Distribution — Wine is not available through normal distribution channels or the demand is so strong that it is only available for a short time after release. The consumer is not going to make the effort if it is available at the local grocery store.
- 2) Special Incentives — Make the consumer feel they are receiving value for their purchase or that they are unique or privileged. This might be major discounts for case purchases, an advance release program or making them a "friend of the winery".
- 3) Convenience of Ordering — An efficient system for mailing list maintenance, packaging and shipping. Take a lesson from the L.L. Bean manual. This is your bread and butter, so you better be good at it.

In the dynamic environment of wine sales, the winery owner should always be aware of the options available for distribution. The successful winery will combine these different methods not only to sell their product but also to maximize revenue per case. ♦



Do Wineries Make Money?
continued

lish solid markets and profitable prices.

Wineries are clearly seeking increased profitability as sales dollars rise faster than case volume. Many are demanding more of their marketing departments and more from their distributors. They are weeding out non-performers and insisting on results. Perhaps this will lead to more incentive-based marketing compensation. Compensation for creating profits, not for moving boxes would certainly be more appropriate than the traditional arrangements.

Overall, premium wine sales growth has been strong, increasing at double-digit rates for several years. Although established brands are generally profitable, profit growth has lagged behind sales growth. And profits will continue to lag until we have more brand maturity and improvements in marketing efficiency. Any industry going through rapid change will have some individual fallout, but the industry is healthy overall.

From our present vantage point in the shallow trough of the current recession, it's hard to see that the premium wine business is in better shape

than it was ten years ago, but it is. We are definitely improving with age.

LONG-TERM PROFITABILITY

Excellent profit potential can be a reality for brands as they mature. This is borne out by the wineries in our group who started in the 1970's. Today, 94% of them are profitable, they have an average F.O.B. of \$90, and they earn an average pre-tax of 26% on sales.

The realization of asset appreciation is the ultimate long-term profit for a winery. Winery sales, including sales of partial interests have generally reflected excellent appreciation. This has been true for some unprofitable operations as well. Some of the "artistic" successes have had lackluster financial results, but have still sold the winery at a profit. Good products, image and location have substantial intangible value to buyers, despite a lack of financial success. With good distribution and profitability, a winery can command an even higher price. However, this realization takes a much longer term than other investments.

BEYOND PROFITS

Most vintners are not drawn to the wine business by the lure of easy money. For many entrepreneurs, it is

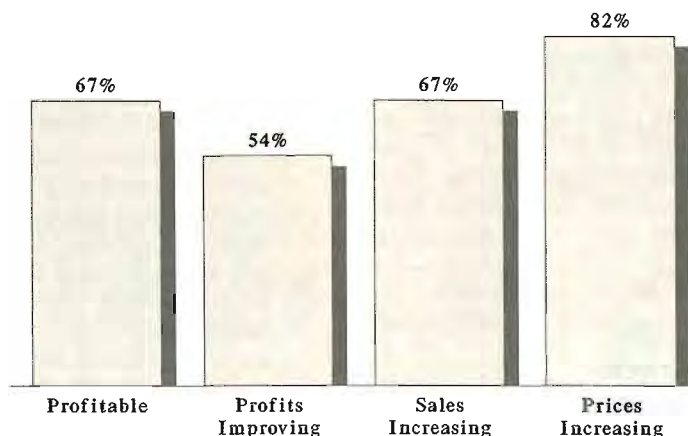
a new and more interesting way of life as well as a fascinating business challenge. In this country, there is the pioneering element; we are definitely blazing new trails. There is also the mystique of wine, the art of winemaking, and country life combined with the glamour of the wine business.

The romance of the grape is real. But, is the good life only a fantasy? Do those who fell in love with the wine business still love it? Most would say that it is not as much fun as it once was. What is? Chances are however, that few would trade back for their former life. *In vino veritas.*

THE BOTTOM LINE

The wine industry is a young, tough and changing business. Not so much a place to semi-retire, but a great way to build a business that can be worthwhile, lasting and profitable. ♦

PROFIT TRENDS
Winery Study Group Results



SOURCE: MKF database

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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