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MOTTO, KRYLA & FISHER
Wine Industry
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WINE INDUSTRY
UPDATE
"Wine industry financial, business and tax ideas."

Chardonnay as a Commodity

Mike Fisher

Has Chardonnay become a commodity to the wine consumer? We think so, and would like to look further into why Chardonnay is by far the most dominant variety in the premium wine business. Prior to the early 1980's Chardonnay was just another variety generally produced by small premium wineries. Since then big changes have occurred. Although Chardonnay represented only 8% of the tonnage crushed in 1991, the value of those grapes exceeded 30%. The tonnage has increased over four-fold since 1982 to over 200,000 tons in 1991.

During the 1980's three market segments of Chardonnay wines developed. More recently these segments have become more segregated from each other, developing their own distinct consumer groups.

The separation of the segments began in the mid 1980's when large quantities of excess Chardonnay were available in the bulk wine market at depressed prices. Marketers, led by Glen Ellen Winery, took advantage of this over-supply and created the fighting varietal, currently retail priced in the range of $5 per bottle.

The producers of fighting varietals focus principally on using the Chardonnay name to sell the wine. This takes advantage of the consumer shift from white wine to Chardonnay as a generic choice. Most of the wines are California appellation, with some non-coastal grapes being used. Since 1984 the percentage of Chardonnay tonnage crushed from the coastal regions has dropped from over 90% to less than 70%. Since labeling laws require Chardonnay grapes to make up not less than 75% of a total blend, fighting varietal producers typically blend in less expensive white varieties. Other costs are kept to a minimum with a short processing and aging period and any oak flavor added as oak chips rather than barrels. The bottling process employs the use of inexpensive packaging materials. Volume (1,000,000 cases or more) and cost containment (production costs of less than $25 per case and minimal marketing costs) are the keys to success in this segment.

Since the late 1980's a new and distinct market segment has emerged, ultra-premium quality Chardonnay at super-premium prices ($10 retail). Success in this segment again is keyed to volume but cost containment in the production process is not the strategy because the emphasis is on

quality. Because of the versatility of Chardonnay in the vineyard, numerous coastal locations from Santa Barbara to Mendocino grow extremely high quality Chardonnay grapes. Using these grapes, french oak barrels and wine-making techniques such as barrel fermentation and *sur lie* aging, a high quality Chardonnay is produced in volume. With this high volume and value to the consumer these wines can be sold with relatively low marketing costs.

The third market segment is the traditional ultra-premium category which retails for $15 or more. These are specialty wines promoted on uniqueness of wine character and style, image of the winery, packaging, etc. Because of the quality of the high volume wines mentioned above, it is difficult for the small wineries to compete on the basis of quality alone. Cost containment (principally marketing) is not possible because of the specialty nature of the product, nor is high volume because of the wine's uniqueness. The success in this market segment depends on the winery's ability to match price with the related high production and marketing costs.

Recently we have seen some interesting trends in the Chardonnay market. Because of the recession, the multitude of labels and the negative press relating to the 1989

Continued on back page

Wine and the Information Age

Vic Motto

The high-tech Information Revolution is changing the world more profoundly than the Industrial Revolution did in the late 19th century. Sweeping changes are affecting the way we live and work, and future changes will be even more dramatic. The effects of these changes are being felt now in the wine business.

Wineries

One day soon you will ask your computer, "How much Chardonnay has Beltramo's bought this year?" After a brief whirr a voice will say, "They bought a pallet in January on deal, but haven't reordered since then." Amazing? The technology exists today. It won't be long before a working practical application is on the market.

> *"Wineries are using the latest technology."*

Today's technology provides wineries with the means to obtain crucial business information, and the analytical tools to evaluate and use it. Wineries are using the latest technology to communicate with maximum speed, impact and effectiveness. Computers, phone systems, fax machines, modems, satellites, electronic bulletin boards, on-line databases, and multi-media interfaces are just the beginning of the Information Revolution.

Something as mundane as winery accounting has been revolutionized by advancing technology. Sophisticated computer accounting systems that cost $200,000 twenty years ago were only $10,000 ten years ago and are available for $2,000 today. Now the smallest winery can have the best available financial information and the analytical capability to use it. Computer tools are helping wineries to evaluate and control costs, manage inventories and receivables, and to analyze sales data. Newer computer programs are evolving to collect and analyze marketing data on a very sophisticated level.

Some of the systems are custom-developed for wineries. Customized systems are expensive and time-consuming to install and learn. The initial projected cost is typically only the down payment. A custom project can easily get stuck in perpetual development. Standardized systems are easier to install and learn, but require some compromise in features. The learning curve on these sophisticated systems can be steep, but the potential payoff is great.

Retailers

Wine retailers are using technology in ways that are changing their wine buying patterns. Scanner data is tied to computerized ordering systems, which are integrated with inventory management systems. Computer systems are being used to measure product profitability and shelf space profitability. The same systems provide information to evaluate the effectiveness of price promotions, advertising, merchandising and cross-promotions. An entire store can be designed for optimum effectiveness using all of this information. Sophisticated retailers are looking for direct payoffs from each product they carry. Today's technology allows retailers to make a precise analysis of every wine in every store. Only the most profitable are reordered.

Market Data

The biggest area of technological growth is in marketing data. Scanner data is now available for supermarket wine sales in 32 different markets. This data includes detailed sales information by brand, product, and market, both in cases and dollars for every week of the year. Sales data can be correlated with data on advertising, merchandising, and price promotions to fine-tune marketing and sales techniques. This is incredible market intelligence not previously available. The scanner technology is now spreading from supermarkets to other types of retailers. The cost is prohibitive for all but the largest wineries, but this will change over time.

> *"Wineries who rely on the traditional approaches will be at a competitive disadvantage."*

Marketing Changes

Technology is changing wine marketing approaches as well. Some wineries use market data, along with computer programs that demonstrate product profitability as tools to market to the trade. Retailers are beginning to exchange marketing and sales information with some of their suppliers. Electronic communication is now used by both wineries and retailers to promote business. There are many creative new uses for electronic media. Telemarketing, 800 numbers, voice mail, on-line computer services, faxes, and video are good tools to reach customers and consumers. Promotional materials and newsletters can be economically produced with desk-top publishing. Retailers use "club" cards tied to promotions, in-store audio and video commercials, and electronic point-of-sale. Consumers use computer bulletin boards and on-line wine databases to make buying decisions. Progressive wineries are taking advantage of these trends.

We are seeing the beginning of a revolution in winery management, marketing and communication. Wineries who rely on the traditional approaches — pushing distributors and hoping for favorable wine reviews — will be at a competitive disadvantage. Tomorrow's winners will use the latest technology to understand consumer trends, speed communication, sell wine and manage for profitability. ♦

Tax Relief — Phylloxera Update

Karen Kryla

Federal Income Tax —
In March 1992, the IRS in Washington outlined their interpretation of the current tax treatment of various costs incurred in replanting a vineyard due to a phylloxera infestation.

First, they have conceded that any of the *original* costs for vines and vineyard improvements which have not yet been written off through depreciation deductions can be written off in the year the vines are pulled. The costs of removal can also be deducted in the year the removal occurs.

They have grouped the replanting costs into two basic categories:

- Costs that you can write-off immediately. (They call these "developmental costs"); and
- Costs which must be capitalized and written off over a period of years through depreciation deductions. (They refer to these as "preparatory costs.")

"Developmental costs" include the annual preproductive farming costs and other costs such as depreciation and interest which normally must be capitalized into developing vines.

"Preparatory costs" include the land preparation, vines, irrigation, stakes, trellis and the labor to install these items. The IRS position is that these items *cannot* be written off in the year of the replanting but must be capitalized and deducted over a period of several years through depreciation deductions.

California Income Tax*
Senator Mike Thompson has introduced a tax bill in the State Senate which proposes that the current 10 year write-off allowed for vines be reduced to 5 years for vines replanted as a direct results of a phylloxera infestation in that vineyard.

The law as currently introduced benefits only vineyards owned by certain individuals, partnerships and S-corporations. It does not include any benefits for vineyards owned by C corporations or for those individuals who, because they have made an election to deduct preproductive costs, must use the longer 20-year life.

MKF is currently working with Senator Thompson's office to expand the proposed relief to these taxpayers.

California Property Taxes*
Assemblywoman Bev Hansen introduced a tax bill which would provide property tax relief for vineyards less than 15 years old with phylloxera.

These vineyard owners would be able to transfer the old property tax base (adjusted by the annual 2% inflation factor) to the new vineyard by filing an application along with a written certification from the County Agricultural Commissioner of the phylloxera infestation.

*These are summaries of the initial bills introduced. If adopted, the final versions and actual tax relief granted will most likely have some modifications. The good news is that legislation is being considered and optimism runs high that some sort of tax relief will be granted. ♦

Choosing an Inventory Method — Should You Use LIFO?

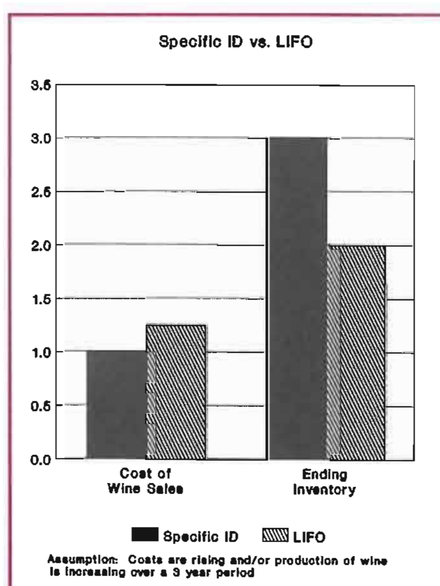
Devonna Smith

What method do you use to cost your wine inventory? Why is it important to know? Can LIFO really save you tax dollars? How you cost your inventory and understanding how these costs match revenue from wine sales are important to the financial success of your winery. Let's look at the different methods of costing wine inventory including specific identification, FIFO (first in, first out) and LIFO (last in, first out). Then I'd like to compare the specific identification method with LIFO and discuss the advantages and disadvantages of each method.

The costs going into inventory are the same for any method of inventory costing. How these costs are allocated among wines and flow out of inventory when the wine is sold are where the differences arise. The costs going into inventory (grapes, winemaking, bottling and overhead) are allocated based on the assumptions relating to the flow of wine through the production process.

- Specific identification method allocates costs to inventory based on the specific vintage and product using the actual flow of physical inventory in gallons and cases. This is probably how you intuitively think of wine cost.
- FIFO — The first in, first out method computes cost of wine sold and ending inventory by removing the oldest inventory costs first, regardless of the actual items sold. This method is generally not used for wine inventory.
- LIFO — The last in, first out method computes ending inventory as if the goods that enter inventory last are sold first. During periods of rising costs this yields a higher cost of wine sold and lower ending inventory. This is due to the flow of costs. LIFO simply increases cost of wine sold which is similar to the cost to replace the inventory currently being sold.

A comparison of LIFO versus specific identification methods during a period of rising prices is illustrated in the graph.



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Chardonnay *continued*

vintage, we see intense competition, with major discounting of some labels. Since the 1989 vintage is beginning to be perceived by consumers as "over the hill" many wineries have been frantically liquidating inventory. It is not unusual to see wines that were initially released at $15 now selling for $10 or less. This is disruptive to the overall market but a reality of the economic law of supply and demand.

It is difficult to predict the future with regard to Chardonnay, because of a number of conflicting trends and "what ifs." From a grape supply side, wine availability is a function of acreage and yield. We have seen a 2½-fold increase in acreage over the last ten years, and expect the central coast region to have continued growth because of lower land costs, in most instances amounting to one-half those of the Napa and Sonoma areas. On the other hand, we see the effect of Phylloxera having a negative impact on grape supply during the next five years because of acreage removals. During this time we see the supply of Chardonnay grapes slowing its increase or possibly remaining level. Then again, with these replantings, we see major increases in supply in the late 1990's and early twentyfirst century for two reasons:

- Since Phylloxera affects all AXR vineyards that are planted to varieties other than Chardonnay, many may be replanted to Chardonnay because of its historically high price.
- Vineyard technology has advanced in the last ten years due to such techniques as closer vine spacing and more advanced trellis systems, so that yield per acre on the new vineyards may increase from a current level of approximately 4 tons to as high as 6 tons.

From the demand side, we will continue the "drinking less but drinking better" consumer mentality which we have seen since the mid 1980s. Another trend is that consumers are becoming more value oriented and are less interested in wine based on image or "perceived" value. As consumers become more sophisticated they are better able to judge quality and will purchase wines based on what is in the bottle rather than on the label. So they are drinking better and paying less for the pleasure. There is also a trend referred to as A-B-C (anything but Chardonnay) which is now relatively minor and is isolated to the "wine freak." Obviously if this trend gains momentum it could have some negative influence on Chardonnay demand.

Another factor which may be positive for the overall Chardonnay consumption but create major problems for individual producers is whether or when Gallo will enter the super-premium and/or ultra-premium Chardonnay market. With their major acreage and a production facility in Sonoma County, they have the components. Because of their marketing strength, all bets would be off. Everyone knows the impact they had on wine coolers after they entered the market with Bartels and Jaymes.

Where all this leads is anyone's guess, but it will continue to change. As the industry matures competition will continue to get more sophisticated, but additional niches and opportunities will always be there for the leaders and innovators. ♦

Inventory Method *continued*

Specific identification method calculates the historical cost of each wine by vintage and product. It's biggest advantage is for management decisions. Areas where specific identification is most beneficial include:

- Budget versus actual comparisons for all direct and indirect costs of the wine on a per case basis
- Long-term planning questions such as —
  - — Source and cost of grapes
  - — Construction of a new facility versus custom winemaking at another winery
  - — Packaging costs
  - — Sales mix by varietal
  - — Economic viability of winemaking technique (e.g. length of barrel aging)
  - — Pricing

LIFO generally shows a higher cost of wine sold representing the *replacement* cost rather than *actual* cost of wine sold. Because LIFO increases the cost of wine sold, taxable income is less resulting in lower taxes. This can represent a significant tax savings.

The disadvantages of LIFO include:

- Lower taxable income also results in lower reported profits
- LIFO balance sheet reflects the inventory at less than cost thereby understating assets and equity
- In a period of deflation, LIFO can result in increased taxable income and taxes
- Lack of comparability of wine cost per gallon/case
- If LIFO is elected for tax purposes it must be used in financial statements as well
- Election of LIFO is binding for all subsequent years until you choose to elect out

Should you use LIFO? That depends on how you answer the next three questions.

1 — Can you use the tax deduction?
2 — Is your inventory production and/or costs increasing?
3 — Can you live with the reduction in reported earnings and equity?

If the answer is yes to these three questions then LIFO probably is the right method for you. ♦

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