Winter 1992

MK·F
MOTTO, KRYLA & FISHER
Wine Industry
Accountants and Consultants

WINE INDUSTRY
UPDATE
"Wine industry financial, business and tax ideas."

The Polarization of Wine

Vic Motto

What is the optimum winery size today? 10 to 15 years ago, the optimum premium winery size most often discussed was 15 to 20,000 cases. Today, that's ancient history.

Trends

The wine industry is polarizing into large and small wineries. Between the small and large successful wineries is a growing "soft zone" where few can flourish. And today, that 15 to 20,000 case winery is squarely in this "soft zone." There are other examples of "soft" sizes in the larger segments.

This trend is due to two factors: First, quality wines are being made on an increasingly larger scale due to improvements in technology and in the wine production learning curve. Second, growing competition and a shrinking distribution system have increased the cost of marketing. As a result, there are greater economies of scale in marketing as well as in fine wine production. Now there are fewer advantages to being small and generally more advantages to being big.

Market Segments

The specific optimum winery size depends on the market segment involved. Obviously, the wine industry is highly stratified into segments, each with very different characteristics. We most commonly use the Popular Premium, Super and Ultra-Premium segment categories. These are rough segments divided on price lines. It's important to note that the old price lines may no longer be the natural dividing lines. Important retail price points are continuously evolving. However, these categories are very useful to the extent that they are commonly used and understood.

There are some other important distinctions between segments besides prices. In fact, there are some real niches based on factors other than price. We do need a more precise identification of wine market segments and niches, but the market research for this has not been done.

Most wineries in each segment are clustered around a common size; one that fits the scale of that segment. A smaller winery in a given segment may be too small to compete on a marketing level with the bigger wineries in that segment. On the other hand, a winery that is bigger than most in the segment may be over-producing for that category. We have seen examples where this over-production has affected a winery's prices and image to the point where they were driven down into a lower price segment.

Every segment is changing, and the optimum size in each segment is changing. In the Ultra Premium segment,

there are many successful wineries both large and small. The middle-size wineries however, are not doing as well. Up to a point, the small wineries can compete based on exclusivity, image combined with high prices, direct relationship marketing, or some combination of these. Beyond that point a winery must be of a significantly larger size to compete effectively on a marketing scale with the larger wineries in that segment.

Optimum Size

Profitability for small Ultra Premium wineries starts to peak at around 5-10,000 cases. Then the Ultra Premium profit curve starts to improve again around 25-30,000 cases. This threshold, however, is rising. A successful Super Premium winery should be well into the six figure size category for optimum scale, but for now, many wineries can compete at the low end of that range. This category is changing rapidly. The segment in the Popular Premium price range is best suited for multi-million case wineries today. Of course, there are exceptions to all of these trends, but the exceptions are really bucking the trends. It's better to operate in the mainstream size group of your segment, or slightly ahead of the curve.

Future Trends

The feasibility of producing fine wine on a large scale has been clearly demonstrated by several wineries. The

Continued on back page

The Economics of Hillside Development — Does It Really Make Sense?

Mike Fisher

Why are vineyards planted in the hills? Throughout Europe, vineyards grow on the hillside. Examples include the Chianti region of Italy and the Rhone and Burgundy regions of France. The rationale for these hillside plantings in Europe is not only higher quality fruit, but also because the valley is better suited for other crops, such as grains, which are difficult to grow on the hillsides. Over the years the regulations in some appellations of Europe have developed to *prohibit* vineyard development in the valleys.

In California many feel hillside vineyards yield grapes of higher quality because of greater fruit intensity. This is undoubtedly attributed to reduced vine vigor, due to the shallow rocky soils, low water holding capacity and low organic matter and fertility. In addition, the longer growing days due to less fog, greater sun exposure and overall cooler maximum summer temperatures contribute to the increased quality. Due to intense fruit character and high extract, many wineries use the hillside wines as blending components with wines from the valley. The characteristics of some varieties such as Cabernet, Merlot and Zinfandel are enhanced by this greater fruit intensity, but little is added for others such as Chardonnay and Sauvignon Blanc.

The economics of grape growing vary widely depending on a number of factors including the slope of the land, the size of the vineyard block, the soils, debt incurred, etc. In most instances gross land costs are less in the hills than on the valley. This can be deceiving though, because hillside parcels purchased for vineyard development include substantial unplantable acreage. Consequently, the cost per net planted acre may be comparable to that of the valley. In addition to this, many smaller parcels of 40 to 80 acres must compete economically as estate homesites because of their proximity to urban areas.

Hillside development costs are greater than those in the valley due to additional costs incurred for land clearing, terracing, surface and subsurface water drainage systems, cover crops, deer fencing, complex irrigation systems, and closer spacing due to less vigorous vines. Alternatively, elaborate trellis systems needed to control vigor, typical of the valley, are generally not needed in the hills.

Additional farming costs for the hillside vineyards include cover crop maintenance, more expensive equipment such as crawlers and specialized sprayers, additional hand labor because of less mechanization, erosion control maintenance, and pest control due to birds, gophers, mice, rabbits, hogs and deer.

The yield on hillside vineyards runs from 50% to 70% of that expected in the valley. In a survey of thirteen hillside vineyards in Napa and Sonoma Counties representing over 700 acres of vines we found an average yield in tons per acre of 2.2 tons for the 1988 through 1991 harvests compared with 4.1 tons for the county averages.

Prices received by growers can be 20% to 30% more than average and we have seen instances where premiums exceeding 50% have been paid.

Vineyard Establishment Costs — Excluding Land

Cost Per Acre

	Hillside	Valley
Development:		
Planting & vines	$ 6,500	$ 3,905
Cultural — 4 years	4,000	3,176
Development	10,500	7,081
Improvements:		
Land clearing	2,500	—
Fencing	1,000	—
Drainage	2,000	—
Cover crop	1,500	—
Trellis & stakes	3,500	1,631
Irrigation system	4,000	1,016
Frost protection	—	1,133
Improvements	14,500	3,780
Equipment, building, etc.	3,000	1,473
Overhead — 4 years	2,108	2,108
Interest	10,000	5,078
Credit for crop — year 3 & 4	(3,840)	(7,680)
Cost Per Acre	$36,268	$11,840

Vineyard Cash Farming Costs

Annual Cost Per Acre

	Hillside	Valley
Cultural Costs:		
Pruning & training	$ 900	$ 551
Weed control	200	45
Cultivation & mowing	300	41
Pest management	300	131
Irrigation	150	83
Fertilizer	100	55
Other	100	70
Harvest	450	600
Cultural Costs	2,500	1,576
Overhead	585	585
Interest on establishment costs	3,627	1,184
Total Cost Per Acre	$6,712	$3,345
Yield — Tons	3	5
Cost Per Ton	$2,237	$ 669

Not all hillside grapes receive premiums, though, only those that have proven high quality fruit.

To show the disparity between the economics of hillside and valley grape growing the accompanying analyses compare costs to establish and farm a valley vineyard taken from the U.C. Extension publication, 1989 Sample Cost to Establish and Produce Wine Grapes in Napa Valley and an *example* of costs incurred for a hillside vineyard. The hillside establishment costs are more than triple those of the valley floor with farming costs approximately double.

What does this all mean? From a grower's perspective, it makes no sense unless substantial premiums are received. A winery can justify hillside development only if it is part of their "estate" concept and/or the grapes are used as an important component of an ultra-premium wine. ♦

Do You Buy Grapes From Yourself?

Karen Kryla

This is THE QUESTION that the IRS is asking with increasing frequency.

If the answer is yes, you have probably separated your vineyard from your winery for business reasons. And because it made economical sense, you may have arranged for the winery to delay paying for the grapes until the wines are sold by entering into a deferred grape contract.

This arrangement has tax advantages as well. The vineyard can take advantage of special provisions in the tax law for farmers. Farmers are allowed to deduct expenses as they are paid and delay paying tax on income until it is collected.

The proper use of deferred grape contracts can save you BIG dollars in taxes. Because of these dollars, the IRS agents will always review your arrangements and documentation upon audit. Their hope is that you have been sloppy in your planning and documentation. If they can find a way to show that not all of your "i's" are dotted or your "t's" crossed, they will be quick to disallow the deduction of your farming costs until the wines are sold.

We deal with the IRS in audits of our own clients, and other accounting firms faced with an IRS winery audit often ask for our advice. More often today, the IRS is asking questions about the relationship of the vineyard and the winery.

We have seen many different arrangements between the winery and the vineyard. Some selling the grapes from the vineyard to the winery, some merely transferring the grapes. Some selling with written contracts, some without. Some with actual grape payments made, others with journal entries made on the books. Some collecting payment the year after harvest, some not collecting payments until the wines are sold. Some with fixed prices, some with contingent prices. Some with a consistent treatment year-to-year, some with no real patterns. Some winery and vineyard owners who are fastidious in all of their record-keeping, some who are more laid-back.

There are currently several cases where the IRS is challenging the timing of the deduction of the farming costs. The cases are throughout various levels of IRS challenge. Some are at the local office level, some at the appeals level, and some are headed for Tax Court.

We've seen cases where the taxpayers have weak arguments and facts to support their position and others with facts and circumstances which range from arguable, to good, to better.

Armed with proper planning and documentation, we believe that your ability to deduct farming costs when you pay for them can withstand IRS attack in the Tax Court. The Tax Court has repeatedly shut the IRS down when the IRS has tried to say that a farmer cannot deduct farming costs when they are paid — even where a cash-basis farmer sold the crop to a related party for processing. The Tax Court has told the IRS that if they are unhappy with this result, they must get the legislature to change the tax laws before the Court will take their side.

However, cases that win always have the proper structure and documentation in place. The "form" of the transaction and the documentation is crucial.

Due to the large dollars involved, the IRS is keen on seeking revenues in this area. The IRS is continuing to look for weak points in your arrangements and documentation — to show that a contract didn't exist or that it was improper. . . any way they can find to stop you from deducting your farming costs until the wine is sold. Because of this effort, we must make sure that we don't leave any doors open for them to enter. Proper structuring, documentation and follow through are critical to keeping the IRS out.

Review your arrangements, check your contract, and then step back and look at all other transactions and documentation between your winery and your vineyard. Have you left any doors open? ♦

The Cost of Mixing It Up — Part II

Judy Skram

In our previous newsletter article, we discussed the importance of product mix to winery profitability. (Product mix is the combination of wine products and their prices). We found changing product mix could significantly improve winery profitability recognizing, however, that making such a change could take several years and might require substantial investment in inventory and barrels.

So that you can weigh the pro's and con's of making a strategic change in product mix, we will now look at the expected payoffs, costs and bottom line in more detail.

In our original case study "Some of Each Winery" produces and sells 2,000 cases each of Cabernet, Chardonnay, Sauvignon Blanc and Gewurztraminer. It has gross margins on these wines from $72 to $12/case, marketing expenses of $24/case and administration costs of $120,000/year. The winery has an annual net loss of $14,000.

Some of Each Winery decides to focus its mix on its higher margin wines — Cabernet and Chardonnay. It eliminates production of Gewurztraminer in Year 1 and Sauvignon Blanc in Year 2.

Future sales of Cabernet and Chardonnay are projected to increase from 2,000 cases to 3,000 cases/year and the winery begins producing those higher quantities in Year 1. The additional cases require an investment in inventory of $32,000 and $53,000 for barrels in Year 1.

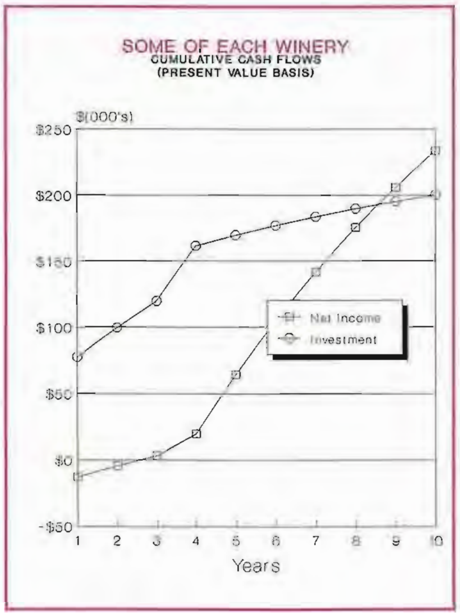
Although Some of Each begins producing for its new product mix in Year 1, the wines it has available for sale that year are the same. Consequently, its net loss for the period is the same — $14,000.

Over the next few years, the winery continues to produce Cabernet and Chardonnay at the 3,000 case level.

continued on back page

Mixing it up *continued*

While this does not increase the NUMBER of cases in inventory (because of dropping the other varieties), it does increase its value as inventory comes to consist, more and more, of older and more expensive wines. Total



cost of wine inventory goes from $828,000 at the beginning of Year 1 to $936,000 in year 5. In addition, the winery's annual barrel replacement cost is now higher by approximately $13,000/year.

Some of Each Winery's profitability gradually improves in years 2 through 5 as the change in product mix begins to take effect. Net income was $10,000 in year 2, $24,000 in year 4 when the first 3,000 case vintage of Chardonnay is sold, and increases to $72,000 in year 5 when the change in product mix is complete.

Was It Worth It?

Yes. In the long run.

In the graph we see the cash flows, in present dollar terms, of the cumulative net income versus investment in inventory and barrels. Present value analysis is used to equalize the timing differences of the investment and increase in net income. At the end of year 5 when the change in product mix is complete, we see that investment has exceeded net income by some $73,000. However, in subsequent years the net income soon begins to swing the balance in its favor. By Year 8 the additional net income clearly outweighs the required investment which had been made in inventory and barrels.

Establishing your product mix or making changes to an existing mix can be a lengthy and expensive process — though ultimately a beneficial one. It requires making decisions today that will be with you for the long term. Analysis such as the one above can help you to think those decisions through BEFORE they start to cost you money. ♦

Polarization *continued*

changes in marketing however, are still rapidly evolving. Marketing economies of scale are attributable to a number of factors. With the dramatic growth in the number of wineries in the 1980's has come increased competition. The number of wineries almost tripled in the 80's. Add in the "zip code" and phone booth negociant brands and you see a very crowded market.

Continuing distributor consolidation is now leading to experimental alternatives. We see new types of broker arrangements coming and going, captive (winery-owned) sales companies, captive distributors, co-op marketing, and many variations on direct sales. We expect to see even more creative experiments along with a continuing game of "musical chairs" among these alternatives. All of these changes tend to increase marketing costs, which creates economies of scale favoring the larger wineries in each segment.

There are massive changes in retailing, along with changing consumer buying habits. When is the last time you paid "suggested retail" for something? In the past, retailers promoted brands. Now they let the brands promote the retail stores by using the product's brand strength along with "value" pricing. Space management, reduced inventories, fewer brands and fewer SKU's are all major trends in retailing. These trends favor larger wineries. Information technology is revolutionizing retail management. The same costly technology must be understood and used by wineries marketing in this environment.

All of these changes in distribution and retailing are requiring wineries to take more responsibility for building and marketing their brands. As a result, marketing costs are being shifted from distributors and retailers to the producers. The smaller producers in each segment are at a distinct disadvantage.

With the responsibility for all marketing being shifted to producers, we're seeing a growing trend toward more direct relationship marketing. If distributors and trade won't do the job, the producers then make an end run directly to the consumers. Some of the most successful small wineries have long used direct relationship marketing. Now it's being incorporated into the marketing programs of some of the successful larger producers.

With the growing polarization of wine precipitated by increased competition and a changing marketplace, wineries must rethink their strategy. The first important point is to look at the other brands in your segment. Make sure that you are a competitive size. Also look at your marketing program with the realization that it's up to you to reach the consumer. Then be sure that you are keeping up with the changes that are occurring in your segment. ♦

MOTTO, KRYLA & FISHER
Wine Industry Accountants and Consultants

NAPA VALLEY:
999 Adams Street
St. Helena, CA 94574
(707) 963-9222

SONOMA COUNTY:
North & Vine, P.O. Box 1524
Healdsburg, CA 95448
(707) 431-2200