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Wine Industry
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WINE INDUSTRY
UPDATE

"Wine industry financial, business and tax ideas."

The Export Potential For California Premium Wine

Michael Young

California wine exports continued to grow in volume during 1992 at an annual rate of about 23%. This represents the fifth consecutive year of compound growth in excess of 20%. Sounds like a great success story, and in many respects it is. Yet there remains tremendous untapped potential for California's premium wine industry. The growing reputation and acceptance of premium California wines, the still positive international image of California, and the expected increasing internationalization of business and pleasure travel will all contribute positively to future growth. But these factors, while important, are not enough to *really* take advantage of the potential!

To really exploit the current opportunities, premium California wineries need to develop a much more proactive approach to exporting. In short, we need to pay more attention to exporting, and to better organize both the individual wineries and the industry overall.

Winery Checklist for Success

Success requires an attitude that says your winery is committed to export, and will do what it takes to succeed.

1. Learn about specific export markets. Travel there if possible. If not, read some of the many helpful books/articles/videos about countries, cultures and economies.
2. Talk to other premium wineries involved. Adopt a cooperative attitude with other wineries. The main competition worldwide is not California, but the wines from a huge array of wine producing countries. Develop relationships with people involved in all aspects of exporting.
3. Designate one winery person to be in charge of exports. This need not be full time, but should be someone very interested in the subject. Treat this job as a very important one.

4. Integrate exporting into your operations policies and budgeting process. Develop export pricing, promotion, travel, production, and shipping policies. Alert all personnel to exporting's importance. Talk about the subject in meetings.
5. Once you begin working with a company abroad, work closely with them. Stay in touch. Keep them informed on products, pricing, etc. Follow up on all promises.
6. Make sure you have a consistent supply of wine to export. Inconsistent supplies can be a knock-out blow. You need not insist that an importer take your full line or those wines in short supply.
7. Be flexible. Export shipments are seldom identical. Different paperwork, stickers, financing, are the NORM. Accept this! Timing is often a more crucial factor than for domestic orders. Stay on top of this. For example: Many European wineries label only on receipt of order, allowing more customization and forcing more flexibility.
8. Set goals; try to make them realistic. Less than 10% of California wine is exported, so consider reasonable targets and growth rates.
9. Be persistent.
10. Be patient.

Continued back page

Value Pricing- What Does It Mean?

Mike Fisher

Recently there has been much discussion about the high price of California premium wines. We hear that the number of wine consumers willing to pay high prices is shrinking - that premium wineries need a "reality check". The industry is being forced to lower prices because fewer consumers are willing to pay $15 per bottle. Is this a temporary or permanent situation?

Many wineries are reacting to this sentiment by focusing on "value pricing" as a concept for selling their wine. The value pricing concept plays into the current consumer trends of purchasing few items at full retail.

Wineries approach the value pricing concept in two ways. The first is to develop a lower priced brand in which wines of the quality comparable to the winery's original brand are produced (e.g. coastal grapes, French oak barrels, labor intensive production and expensive packaging). The wines that continue to be bottled under the more expensive original label may have unique characteristics such as vineyard or "reserve" designation, but the quality of the wine is similar. This concept is different from the traditional second label approach, in which purchased bulk wine or lower quality lots are used.

The second approach is to produce all wine at high quality standards and to promote the winery as a "value priced" winery. A tag line such as "high quality wine for every day consumption" can easily be promoted without explanation.

Value pricing is great for the consumer, but what are the economics for the winery? Since revenue is less because of lower pricing, one must look at a reduction of costs to make the formula work. Because the winery is selling the idea of higher quality for less money, a reduction of production costs reduces quality and as a consequence is self-defeating. Distribution and administration expenses lend themselves to some reduction but not at the magnitude of sales and marketing costs. Reduction of the traditional sales and marketing expenses is critical to the success of the value pricing concept. These expenses include public relations, hospitality, entertainment, travel, marketing materials, commissions, distributor support, payroll, etc. A value priced brand can't justify extensive travel, sales reps, elaborate entertainment, comprehensive POS materials or a high powered PR firm. The wine needs to be sold through guerrilla marketing techniques.

Because a wine is value priced, and in theory will sell itself, the winery could look to the distributors and the trade to reduce their margins allowing the winery to receive a higher percentage of the retail price.

A comparison of the economics of value versus traditional priced wine might be:

	Value	Traditional
Bottle price	$ 10	$ 15
Retail/FOB price %	55%	50%
Per Case-		
FOB price	$ 66	$ 90
Programming	-	(5)
Production costs	(40)	(40)
Gross Margin	26	45
Sales and marketing	(10)	(25)
Distribution	(4)	(5)
Administration	(5)	(7)
Profit Contribution	$ 7	$ 8

Some of the cost savings would come from lower expense and others through higher volume.

Lastly is the question of whether the value pricing concept is temporary or represents a trend which will be a permanent structural change to the industry. We see a number of factors which offset the consumer trends favoring value pricing and indicate it may be a temporary phenomenon. These factors include:

•We are in the middle (or at the end?) of a recession, especially in California which represents 40% of premium wine sales. This recession has been with us for two years and has especially hit white collar (higher percentage of premium wine consumers) vs. blue collar workers. Restructuring and consolidation of many industries is occurring, raising job security questions for many more employees than have actually lost their jobs. Everyone is less inclined to buy expensive wines; however, recessions historically are cyclical, and the economy will recover.

•The 1989 and 1991 vintages from the North Coast were bumper crops (over 30% above the five year average of 1984-1988) and the 1990 vintage was 10% above average. Demand for premium wine hasn't kept up with the increased supply.

•The media has declared the vintages of 1988 and 1989 Cabernet and 1989 Chardonnay, which are currently on the market, as below average. Many consumers of $15 - $20 wines read vintage charts and wine reviews.

•The wild card of phylloxera will have a major effect on grape supply in the mid 1990's. Projections from our last issue of *Wine Industry*

Continued back page

Winery Tax Audits Up

Karen Kryla

California Franchise Tax Board jumps onboard ; Central Coast wineries to receive more IRS attention

Wine Industry Tax Audits -

We're continuing to see many tax audits targeted directly toward the wine industry. More recently, we've seen the Franchise Tax Board taking an active interest . The Franchise Tax Board auditors are being guided in large part by the local IRS wine industry audit team. The California auditors are using the IRS wine industry audit team as a resource to point out issues and transactions that the IRS feels would be ripe for adjustment.

Trends -

Areas receiving the most attention in recent audits have been:

- •Grape sales between commonly owned vineyards and winery
- •Costing of wine inventory
- •Method of applying LIFO computations to wine inventory

Proper documentation and adherence to your contracts will be very important....

Documentation continues to be a critical factor in related party transactions. The local IRS industry audit team wants to disallow deferral of gain recognition beyond one year when a vineyard sells grapes to a related winery. There appears to be little authority for this position, however the audit team is persisting in their disallowance. Although we believe that a properly structured deferred grape sales contract is appropriate and sustainable, the position taken by the local IRS audit team may mean that anyone audited with this type of arrangement in place may need to go beyond the local levels to Appeals or even ultimately to Tax Court to have their position sustained. Proper documentation and adherence to your contract will be very important at these levels of audit. Your contracts should be written, entered into before harvest, and should not contain any illegal terms. Payments should be made in accordance with the contract. The winery should avoid making any other payments to the vineyard which the IRS might construe to be payments for grapes.

If you purchase grapes from a related vineyard which defers collection of the grape sales proceeds beyond a single year, we recommend that you review your grape contracts to see that the proper documentation is in place and the underlying operation supports your position for deferral.

Central Coast Audits -

Central Coast wineries will soon have their own IRS wine industry audit team. Members of the Napa/Sonoma IRS wine industry audit team have recently been involved in training some auditors in the Monterey and Paso Robles area. Like the wine industry audit team in Napa and Sonoma counties, these newly-trained auditors will be concentrating their audit attention on wineries and vineyards in their geographic area. ✻

Bulk Wine Market, Is It The Answer?

Tim O'Leary

The combination of recent large grape crops and decreased sales growth rates has left many wineries with excess inventories.What options do wineries have when dealing with these excess inventories? Wineries with excess inventory have two courses to choose from: bottle the wine and sell through the most appropriate channel (private or second label, value pricing, deals, etc.) or sell on the bulk wine market.

Although bottling the wine is a popular choice, selling wine in the bulk wine market involves a number of issues from both a seller's and a buyer's perspective.

First the seller:

Pros-

- Decrease excess inventories
- Cash generator
- Sale of lower quality wines
- Sale of lots which don't fit main blends due to style and quantity

Cons-

- Wine bottled by others
- Current soft market for bulk wine
- Bulk price may be less than production costs

Inventory costing spreads costs among wine equally, and generally by the sale of bulk wine results in a loss. If only incremental costs are included, the loss is frequently minimized or perhaps a small profit is realized. Most production costs (facilities, equipment depreciation, most labor, ect.) of a winery are fixed and incurred

Continued back page

Bulk Wine Market *continued*

whether the wine is produced or not. An example might be:

	Full Cost	Incremental Cost
Cost per gallon:		
Grapes @ $1,500/ton	$ 10	$ 10
Crush & fermentation	2	-
Processing	2	-
Barrel aging	3	1
Cost Per Gallon	$ 17	$ 11

Now the buyer:

Pros-

May be profitable
Expand market

Cons-

Very competitive
Market for negociants

Some buyers of bulk wine have been able to overcome the disadvantages and have been successful using other wineries' wine.

Before wineries enter the bulk wine market, both the buyers and sellers have many aspects to look at before determining if the bulk wine market is correct for each winery's philosophy.✻

Value Pricing *continued*

Update predicted a 35% drop in Napa and Sonoma grape supply by 1997. Again, supply and demand economics will cause higher wine prices.

Value pricing can work, but only if sales and marketing expenses are kept to a minimum and volume is high. Those who embrace the value pricing concept should have the ability to phase out of it without major difficulty if and when the consumer demand for more expensive wine returns.✻

Export Potential *continued*

Industry Organization

Much still needs to be done to upgrade the worldwide image of California wines. Even though progress has been made, the task has only begun. This may be difficult for many premium producers to realize, but is true nonetheless. As an example, recently we were negotiating on a large order of wine to India. After several months of intermittent communication, we were informed that California wines would not be "suitable" even though wines from many countries, including Australia, were being considered. Our contacts were good enough to learn that the anti-California decision had come from a high ranking executive in the buying organization as the decision had moved up the ladder toward final purchase. Unfortunately, this is not an isolated case.

New, creative trade organizations with the sole purpose of supporting exporting are needed. Many other countries have such organizations, but California has not yet made much progress. Premium wineries should consider banding together for exporting, similar to many of the joint marketing efforts already in existence domestically. Or totally new organizations should be considered. France has been a leader in this field. They have long had SOPEXA and other regional organizations, whose mission is to promote French wine (and food) worldwide. A California version could take many different forms, but should have as a core mission the successful exporting of premium California wines. The organization should be highly visible, and be active in promotion, provide information, take orders, handle shipping/ consolidating, help with financing, etc. In short, to make the features and benefits of California premium wines well understood, and to make it as easy as possible for countries around the globe to import and sell premium California wines.

Conclusion

The recent success achieved by premium California wine exporters has been the result of strong effort, but much more needs to be done to bring more concentrated focus on exporting as a key ingredient for growth. Combining focus with organizing, both internally and externally, can go a long way toward achieving the truly dramatic growth potential that exists.✻

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