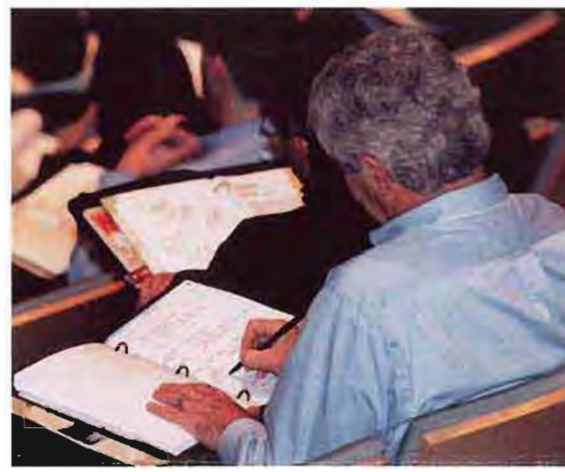
THE MKF ADVISOR
WINE BUSINESS UPDATE
SPRING • 2004

The Luxury Wine Trends Annual Conference '04: *Defining Luxury*

Over 175 wine industry executives heard numerous experts from around the country share their insights about the many facets of luxury wine at the fourth Luxury Wine Trends Annual Conference held on February 22nd and 23rd. A few of the highlights from the conference that included topics ranging from the latest on-premise trends to big box retailing to understanding the luxury consumer are recounted below:



Joshua Greene, Editor and Publisher of *Wine and Spirits* magazine kicked off the conference with a sneak peak at the magazine's annual restaurant poll. Greene noted that the on-premise market had completely changed in the last few years as consumers have become more willing to try new varietals and brands. The results of the poll indicated that Pinot Grigio/Pinot Gris has bumped Sauvignon Blanc from the second spot after Chardonnay in terms of popularity share in restaurants. In addition, Pinot Noir and Syrah have increased popularity, whereas Cabernet Sauvignon and Merlot have both dropped. Other notable trends included on-premise sales of Italian wines, which reached a 10-year high as diners switched from French wines to Spanish and Italian brands.

The "Big Box Retail" panel countered concerns voiced by luxury producers that having their product in Costco, Trader Joe's, Target, or Sam's Club tarnished the brand image. Bob Paulinski, Master of Wine and Chief Wine Merchant of Sam's Club, pointed to the upscale demographic profile of its 47 million members and the similarity to the typical luxury wine consumer's profile. He added, "wine is a logical product for Costco because it is a consumable good and will drive members to frequent the clubs more often." Paulinski plans to expand the club's wine selections with an on-line extension in the next year to year and a half.

Michael Lawrence, National Wine Buyer for Trader Joe's, noted that Trader Joe's customers expect to find deals in the store and don't think less of a brand just because they can find it at a lesser price at Trader Joe's than at the neighborhood wine retailer or on a restaurant wine list. Annette Alvarez, Regional Wine Buyer for Costco, dispelled a common misconception about the quantity of product required by a large club. "Costco will take as few as 5 cases of wine; we don't require, nor necessarily want, 5 truckloads," she said, and added that the company wants to reinforce a "treasure hunt" mentality by constantly adding new products in different locations around the store.

The Luxury Wine Trends Annual Conference for 2005 is tentatively planned for late February, 2005. To be put on the mailing list to receive advance notice and special pricing for next year's conference, please email your contact information to Carla Poggemeyer at cpoggemeyer@mkf.com

Inside

Back

MKF

—**Doug Hart**
is the partner in charge of the audit practice at Motto Kryla & Fisher LLP. Prior to joining MKF, Doug was with the Big Four accounting firm, KPMG, for over 20 years and was Partner in charge of KPMG's Consumer Industries Practice for the Western Region for the past ten years.

Partner Comment

"It's a crowded, confusing market and in confusion there is profit."
–Tom Watson,
Former IBM CEO

While the economic climate appears to be improving, it is clear that there is more competition than ever. MKF's recent SKU survey indicated that the number of wines was outpacing sales. A common message from our recent 2004 MKF Luxury Wine Trends Conference was an increase in the number of luxury brands and wineries.

How do you profit in this crowded and confusing market? One solution is to ensure that you are investing in strategically-focused sales and marketing resources to rise above the competition. Another solution, which is addressed in this issue, is to continually rationalize your product portfolio. While these are timeless strategies, they are essential to your winery's success in 2004.

Prune Your Portfolio and Bui

Do you analyze your brand portfolio for pruning opportunities as often as you prune your vineyards? Although it takes tremendous discipline to identify weak brands or wines and kill unprofitable ones, without regular pruning many winery product portfolios become chock-full of losing or marginally profitable brands and wines. The proliferation of wine SKUs (store keeping units) has exacerbated the problem even further. MKF's recently released *Wine Trends Quarterly Report: Competitive Concentration* found that California brands alone accounted for 5807 SKUs in 2003, a 6% growth rate over 2002 and a significantly higher rate of growth than that of California wine shipments.

The surprising truth is that many wine products don't make money. Many wineries earn almost all of their profits from a small number of wines —smaller than the 80/20 rule of thumb suggests. A recent *Harvard Business Review* article, "Kill a Brand, Keep a Customer," December 2003, proposes that this is not just a wine industry challenge: "Many companies generate 80-90% of their profits from fewer than 20% of the brands they sell, while they lose money or barely break even on many of the other brands in their portfolios."

THE HIDDEN COSTS: THE C.I.R.D. SYNDROME

1. Complexity. Multibrand strategies and large product portfolios require coordination—from production and packaging changes—to distributor relationships and retailer promotions. This coordination requires costly managerial resources and time-consuming price and inventory adjustments. Moreover, you will bear the biggest cost of brand proliferation not in the present, but in the future. As your brand manager focuses on present concerns such as budget allocation issues and inventory turn, future planning takes a back seat, making you more vulnerable to rivals who are more future-focused and disciplined.

2. Inefficiency. Wineries that maintain a large stable of brands or wines in a single brand portfolio, each operating on a relatively small scale, incur large setup costs (vineyard, winemaking and packaging) which result in higher production costs. Addtionally, the impact of your sales team may be diluted by attempting to leverage the sales force across all of the brands.

3. Retailer Margins. A retailer may only agree to carry all of your brands, including the weak and marginal brands, if you offer substantial promotional allowances and higher margins.

4. Differentiation. When your brands or wines compete with one another, they often end up cannibalizing each other. As a result, your revenues do not grow and may even decline, while costs rise.

INSTILL BRAND DISCIPLINE

Begin the rationalization process by conducting a brand portfolio audit (see Quick Audit). It is important to allocate fixed and shared costs to each brand as well as to survey your retail customers to understand how you are performing in the market. In order to prune the portfolio, you will need to develop and apply consistent decision criteria that support the profitable growth of the brand.

—**Deborah Steinthal**
is a diverse businesswoman with over 25 years of management and leadership experience with companies large and small. She helps wine business owners, principals, and executives with strategy development, business planning, organizational and executive development decision-making. As an executive advisor for MKF, Deborah leads the Winery CEO Forum—an executive program for an exclusive group of winery CEOs who seek stimulating discussion focused on critical leadership challenges.

1 Brand Equity

By Deborah Steinthal

Take time to prune your portfolio on a regular basis. By rationalizing your portfolio, you will be able to reduce hidden costs, maximize profits and, perhaps most importantly, better serve your customers.

We frequently observe a decline in hidden costs when a winery reduces the number of brands they sell or the size of a wine portfolio (see Impact of Killing a Non-Performing Brand). In fact, you can also show improved performance by deleting declining and marginally profitable brands. You can use the resources you've freed up to make your remaining brand(s) stronger and more attractive to customers. ***Thus, killing a non-performing brand or wine can be the best way for you to serve both customers and shareholders.*** Done right, portfolio rationalization can result in a winery that is profitable and poised for growth.

IMPACT OF KILLING A NON-PERFORMING (FICTIONAL) WINE BRAND

Key Indicators*	**Scenario A** Winery with multiple brands	**Scenario B** Winery **minus a non-performing brand**
PROFITABILITY		
Operating Income	$3,105	$3,240
PERCENTAGE OF SALES		
Gross Profit	61%	63%
Operating Expenses	38%	35%
Operating Income	23%	27%
CASES SOLD	60,000	45,000
AVERAGE RETAIL PRICE/CASE	$26	$30
OPERATING COSTS/CASE		
Sales - Overall	$224	$264
Cost of Wine	$87	$99

*A few key indicators were chosen for illustration purposes

QUICK AUDIT

Yes	No	
☐	☐	Are we losing money on any of our brands or wines?
☐	☐	Are any of our brands category laggards or losers?
☐	☐	Are we unable to match our competition's marketing muscle?
☐	☐	Do any of our brands overlap in our portfolio?
☐	☐	Do our customers think our brands compete with each other?
☐	☐	Are retailers stocking only a subset of our brand portfolio?
☐	☐	Does our sales team have a hard time prioritizing which wine to show on a sales call?
☐	☐	Are we discounting some of our wines on a regular basis to push inventory?

Totals Yes: ______ No: ______

If you answered "Yes" to: **0-2 questions:** minimal brand rationalization opportunity
3-6 questions: considerable opportunity to rationalize your brand(s)
7-8 questions: rationalization should be a top priority

Winery Accounting and Finance for CFOs

In conjunction with the University of California at Davis, Doug Hart will be conducting an advanced class on winery accounting and finance designed specifically for winery financial executives.

The course covers winery accounting, including inventory costing, vineyard accounting and taxation. In addition, lenders from the winery banking community will be on hand to join the discussion about financial forecasting and share their perspective on winery business accounting and financial practices.

The class will be held on **Thursday, May 20th from 8:30 am – 4:30 pm** at the Wine Business Center, 899 Adams Street, in St. Helena.

To enroll, go to: www.extension.ucdavis.edu/winemaking
or call 800-752-0881.

MKF in the News:

Excerpt from The Wall Street Journal
By Robin Sidel

Deal for Oenophiles: Two Wine Advisors to Merge Operations

Global Wine Partners Aims to be Inverstment Bank for Fragmented Industry

Pop the cork – Maybe the merger business really is ripe after all. In a sign that at least some deal makers are betting on a new burst of activity, two wine-advisory firms are merging to form a boutique investment bank dedicated to the grape stuff. Specifically, it will specialize in the merging of wine companies.

Global Wine Partners LLC, which describes itself as "the wine industry's first global wine-investment bank," plans to take on bigger rivals by touting an expertise in the fragmented business.

"It's an extremely complicated business with a long operating cycle," said Vic Motto, chairman and chief executive of the new company. Global Wine Partners is a merger between U.S.-based MKF Group LLP and International Wine Consultants Pty Ltd., which has offices in Sydney, Australia, and in Paris.

Mr. Motto predicts a wave of deal making during the next few years as large wine companies seek to capture the broad market where prices can range from $2 to $200 a bottle.

There has been some consolidation in the wine industry, which in recent years has been hurt by overplanting, a glut of new wineries and economic recession.

Constellation Brands Inc., in a deal that made it the world's largest wine marketer, bought Australian wine producer BRL Hardy for $1.4 billion last year.

In 2001, Napa Valley's Robert Mondavi Corp. bought Arrowood Vineyards & Winery for $18 million and Foster's acquired Napa Valley's Beringer Wine Estates Holdings Ltd. for $1.5 billion.

The firm plans a formal launch next week with a tour of five Australian cities. "We'll be drinking plenty of wine on this trip," Mr. Motto said.

MKF professionals are the leading wine business advisors, providing CPA services, business consulting, industry research, and mergers and acquisitions services to the owners and managers of hundreds of premium wine businesses around the world for over twenty years.

For more information about MKF's services, please call Doug Hart: 707-967-5316 or e-mail dhart@mkf.com

International Research Executive Joins MKF

MKF is pleased to announce that Barbara Insel has joined the firm as Managing Director, Research Department. Barbara will lead the firm's research division, continuing to enhance and expand MKF's research offerings to help wine businesses compete successfully in global wine markets.

Barbara combines a passion for the wine industry with more than 20 years experience in economic, business, and financial research, and international investment in the US, Latin America and Europe, including senior positions at major investment banks including Salomon Brothers and Kleinwort Benson. She also helped found the European Bank for Reconstruction and Development, leading one of its major divisions, and managed investment companies in Prague and Moscow. Earlier, Barbara was a senior officer of the World Bank, strategist at Continental Grain Company, and an International Affairs Fellow at the Council on Foreign Relations in New York. Since returning to the Bay Area, Barbara has been an advisor on strategic investments, shareholder relations, and international acquisitions to major financial and consulting firms.

MKF

The Wine Business Center
899 Adams Street, Suite E
St. Helena, CA 94574

707.963.9222
707.963.1379 Fax
www.mkf.com

MKF WINE BUSINESS Bulletin:

SPRING 2004

Variable Trends Indicate a "Mixed Bag" for California Wineries

By Phil Bradley

Shipment data from 2003 collected by MKF as part of the *Wine Trends* project, indicate that California wineries continued to post variable results. While some wineries showed double-digit growth, others dipped further into negative territory. California wine shipments increased overall for 2003 fueled by low-end (under $8 a bottle retail) and high-end wines (over $15 a bottle retail), while shipments of mid-priced wines were mixed.

As many vintners will attest, discounting continued to be the price to play, particularly in the mid-price category where discounts pushed many wines into the low-end price segment. Evidence suggests that super value wines have not had the desired effect of luring new consumers to wine, but in fact, have caused existing wine consumers to substitute under $6 wines for mid-priced wines.

Phil Bradley
Research Manager, MKF Group, LLP

Particularly outside of California, imports also pulled sales away from California vintners in the low-end and mid-priced segments. Vintners should not necessarily count on the weak American dollar to protect them against import competition. Grape supplies in Australia, Chile, and Argentina should see large increases in 2004, with Australia potentially producing 30% or more of grapes like Cabernet, Shiraz, and Chardonnay. This potential decline in grape prices could enable imports to maintain their lower prices despite the declining U.S. dollar.

In California, recent research at MKF has shown that new brands and labels are being introduced at a faster pace than sales, while at the same time the number of wine distributors has been steadily decreasing.

The outlook for 2004 could be summed up as optimistic but challenging. Growing consumption, a national economic recovery, and a shrinking surplus of California fruit should all bode well for California vintners. However, increasing competition, both domestic and foreign, will continue to pose a challenge for vintners. Success will come to those who understand their markets and are able to adapt quickly to the changing times.

MKF's *Wine Trends Annual Report*, scheduled to be released next month, is the only report that tracks California wine shipments by varietal and price segment. This report allows you to see growing trends, benchmark your wines within a price category, and plan future production. The *Wine Trends Annual State Report* can help you plan distribution and allocation goals by showing you the trends in state consumption of California wines by varietal and price segment.

The *Grape Trends Annual Report* deals with the supply side of the California wine industry. It allows you to better negotiate future grape contracts and plan vineyard plantings by giving you an accurate picture of grape prices by region, future production, and bearing acres.

For more information on the Wine Trends project or to inquire about MKF's custom research capabilities, please contact Phil Bradley at (707) 963-9222 or pbradley@mkf.com