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Should Napa Valley Cabernet Producers Adopt a Bordeaux Pricing Strategy?

By Patrick Kozel

Bordeaux is not Napa, although as premier wine growing regions, comparisons between the two run rampant, but are intrinsically flawed. Each is distinct with different *terroir*, weather patterns, and production volume. Despite these differences, there are those who continue to criticize Napa pricing and encourage the adoption of a Bordeaux style pricing strategy. The differences that effect Bordeaux and Napa should be recognized as precisely the reasons why Napa should NOT adopt a Bordeaux pricing strategy.

For instance, *Wine Spectator's* "Vintage Charts," indicate that Napa's quality is more consistent than Bordeaux's. Over the last 25 years, California Cabernets scored higher on average (90 points vs. 85 points), and had a lower standard deviation. The 1990's variance was even more extreme, with California averaging 94 points to Bordeaux's 84 points. Bordeaux production is also five times the size of Napa. The average production from the 60 Classified Growths in Bordeaux exceeds 16,000 cases, while average Cabernet production from Napa wineries is less than half that amount.

Despite these differences, *Wine Spectator* recently compared Napa and Bordeaux pricing in their December 15th 2002 article "Sky High Wine Prices." Unfortunately, the article neglected to address the differences highlighted above. More important, they compared the outstanding 1990 Bordeaux vintage, which rated 97 points, with the weak 1999 California vintage (83 points), thus making it appear as if Bordeaux prices have moderated, when they instead were simply adhering to the Bordeaux model. Analysis of price growth from two comparable quality Bordeaux vintages, 1990 and 2000, reveals an extremely high 14% Compound Annual Growth Rate (CAGR). Conversely, the Napa sample set's prices showed only a 10% CAGR from 1990-1999.

It is these and other fundamental differences between Bordeaux and Napa that should discourage Napa wineries from adopting a Bordeaux pricing strategy for their Cabernet. The consistent quality in Napa and California enable its wineries to maintain their prices from year to year. In the rare weak vintage, it will take more time to sell through, but more often than not, this weak vintage will be preceded and followed by outstanding vintages that sell out in less than a year, thereby compensating for the extra time required to sell through the weak vintage. Additionally, MKF has analyzed different pricing strategies for Napa wines that indicate *wineries that hold or increase prices, rather than dropping prices in weak vintages, will earn higher revenues, even if the winery doesn't sell through their entire production.*

Clearly, Bordeaux is not Napa in terms of quality, consistency or size. If the two regions are different in these aspects, why should they employ the same business strategies?

The **Bordeaux vs. Napa Cabernet Pricing Models** study is featured in the *Wine Trends Quarterly Report, First Quarter 2003.* For more information about receiving a complimentary copy of this Report, please contact Lisa Anthony at (707) 967-5322.

—Patrick Kozel
As a Research Consultant, Mr. Kozel helps wineries better understand their position within their market through benchmarking, peer group assessments and other custom research.

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John Heymann, CEO
Mr. Heymann has over 25 years experience in business and organizational development.

CEO Comment

Much has been made of the accelerating pace of change in the wine industry brought on by globalization, competition, and the economy. How does all the noise translate into action?

Part of the phenomenal success of U.S. wine over the past 20 years has been the tremendous amount of experimentation and innovation in both the vineyard and in winemaking techniques. Vintners and viticulturists immersed themselves in the details, hungry for information, sharing techniques and experience, and always pushing themselves and others to create the best wines they could.

Today, wine enterprises have to apply the same amount of effort and passion to the business of wine as they have in the past to the crafting of wine. It is no longer enough to produce a consistently terrific product and wait for customers to beat a path to your door.

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The Changing Role of the Winery CEO – Part 2

The Rush to Win the Consumer

By Deborah Steinthal

*Current wine industry dynamics of increased competition and consolidation are revolutionizing how winery CEOs manage their businesses. This article is second in a series that describes **best planning practices** that wine industry leaders are implementing in support of their growth strategies.*

The top buyer at a leading Chicago luxury restaurant recently said, " They (wineries) need to create better brand identity. The marketplace is crowded. Moreover, the consumer is brand-focused. Wineries are not very smart about this. They are too focused on revenues from the distributor and this is not the whole story." Indeed, with distributor and large winery consolidation in the headlines of the moment, wineries that are successful have discovered creative strategies for getting the consumers' and trade's share of mind.

Some winery CEOs are re-focusing their efforts on distributors who best represent their brand in the right markets and managing that relationship more closely than in the past. Small wineries with strong brands can benefit by working with new, smaller distributors who can give them more attention. Other wineries are re-aligning their sales team with a stronger focus on trade.

One winery announced publicly that it is strengthening brand-building activities by reducing the number of people working directly with distributors, while expanding the number dedicated to global branding and field marketing. More importantly, wineries are learning to work directly with trade by providing a stronger value proposition that helps retailers be successful with selling the winery's brand.

Whereas in the past, brand-building activities focused on events like co-sponsored winemaker dinners and joint wine education programs, today wineries need to go much further to develop stronger brand differentiation and awareness. For example, a small high-end Napa winery has been effective in getting *hundreds* of placements on prime time TV shows for their wines, resulting in greater attention from their distributor and trade customers *and* a 35% increase in sales revenue. Other wineries are opening second tasting rooms, improving the consumer experience through wine education, or participating in cooperative tasting rooms strategically located in desirable tourist destinations.

The benefits can be substantial when a winery develops a successful brand-focused strategy but there can be costs involved. Changes in distributors disrupt sales and hurt market share while relationships are transitioning. The CEO has an important role during this process and must work closely with his or her top sales executive as they gain commitment around a new plan. Similarly, CEOs who are re-aligning their sales team with trade face major challenges: incentives need to change, marketing and sales programs need to change and, sometimes, people need to change.

—Deborah Steinthal
Deborah Steinthal is an executive advisor with MKF. She helps winery CEOs with strategic thinking, business planning and market strategy. Deborah leads MKF's CEO Forum – an executive program for an exclusive group of CEOs who seek stimulating discussion focused on critical leadership challenges.

Could Your Business Benefit From Tax-Free Dividends?

By Wendy Petersen, CPA

President Bush's proposed tax plan, called the "Jobs and Growth Act of 2003," has been introduced to the House and Senate for analysis and debate. Included in this plan is the proposal to eliminate income tax on dividends. MKF's tax specialists are keeping a close eye on this legislation because, if passed, our clients could face some tremendous tax-saving opportunities. If the plan is passed, *many profitable businesses could benefit from incorporating*.

POTENTIAL BENEFITS:

- **Cash out:** Shareholders could take cash out in the form of dividends without paying tax. No more buildup of excess earnings and trying to find ways to get it out.
- **Payroll taxes:** Only wages of shareholder-employees would be subject to income and payroll taxes, not dividends.
- **Reduced capital gains:** Retained earnings of tax-paying corporations would increase stockholders' basis of their stock, ensuring that these retained earnings are subject to tax only once. The result? Lower capital gains when stock is sold.
- **Fringe benefits:** Corporations can provide non-taxable fringe benefits to employee-owners, such as health insurance, housing, etc. Such benefits are taxable to owners of S-corporations, partnerships and LLCs.
- **Lower tax rates:** As shown in the chart below, corporate tax rates may be more favorable, depending on income. (see chart)
- **Simplify the sale of your stock:** Stock can be sold without the complexities that come with the sale of partnership or LLC interests. Instead of unexpected adverse consequences in certain circumstances, you simply have capital gain or loss.
- **Fiscal year-end:** Corporations can elect a year-end based on business cycle rather than calendar year.

If you are already incorporated, you may want to take advantage of the new opportunities available as you address such difficult issues as appreciated real estate, succession planning, and estate planning.

The full implications of this tax proposal are not yet known, but we're watching it closely, and will be ready to assist wine businesses in analyzing and implementing tax saving strategies. To find out if your business could benefit from the tax savings this pending legislation offers, please call MKF.

—Wendy Petersen
Ms. Petersen is a partner and Director of CPA Services with MKF. She provides tax planning, advisory and compliance services specific to the wine industry.

Taxable Income	Corporate Tax	Individual Tax	Difference *(Corp–Indiv.)*
$100,000	$22,250	$20,796	$1,454
$300,000	$100,250	$86,813	$13,437
$500,000	$170,000	$163,759	$6,241
$1,000,000	$340,000	$356,759	– $16,759
$10,000,000	$3,400,000	$3,830,759	– $430,759

CEO Comment
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Excellence and imagination in sales and marketing, strategic planning and execution, best use of capital and human resources, financial management, and product distribution will define the success stories in this current phase of industry maturation and consolidation. Where do you want your wine business to be in 2023?

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MKF in the News:

Wine Industry Business Journal, March 2003
High-end Wine Sales Slow
By Jeff Quackenbush

NAPA -- Producers of high-end and luxury California wine reported continued growth in shipments in 2002, albeit at a slower pace than in 2001, according to St. Helena-based wine business consulting firm Motto Kryla & Fisher. Within the high-end segment, luxury wine grew faster, but its year-over-year growth rate fell.

Wineries shipped 6% more cases of high-end wine (retailing for more than $15/bottle) last year than in 2001, compared to 9% growth from 2000 to 2001. Narrowing the focus to the luxury segment (more than $30/bottle) revealed shipment growth of 8% last year, versus 19% in 2001. MKF partner Vic Motto presented those preliminary findings from the firm's Wine Trends Annual Report, due out April, at MKF's Luxury Wine Trends conference at Copia in Napa in late February.

As in MKF's report on the 2001 market, the 2002 *Wine Trends Report* shows split results from individual producers. Fifty-five percent of wineries reported sales increases last year over 2001, with some increases as high as 40%, according to Mr. Motto. The rest had the same or fewer case sales in 2002, with some selling up to 20% fewer cases.

Luxury-tier Cabernet Sauvignon sales grew last year, while sales of similar-class Chardonnay and Merlot wines decreased, according to the report. Merlot suffered the greatest percentage drop in case shipments (down 5%) and revenue (down 11%). The reverse was true for the same varietals in the broader high-end segment, with Merlot gaining the greatest percentage increase in case shipments (9%) and revenue (8%).

Wines retailing for $8-$15/bottle slightly edged out luxury wines for greater case shipment growth in U.S. markets last year, and the mid-tier segment had case and revenue growth for Cab, Chardonnay, and Merlot, MKF's figures indicate.

Other revelations at the conference came from MKF's first opinion survey of consumers of high-end and luxury wines. Conducted for the event by Stanford, Connecticut-based InsightExpress, the online poll of 325 screened consumers found that 69% were not swayed by retail discounts in choosing the wine they wanted. That held true for consumers in the $15-$30/bottle and over-$30/bottle segments, according to MKF research director Christian Miller, who noted that the results concurred with his research last year of store scan data.

"It implies that the discounts prevalent in the industry are driven by the trade and competition between wineries rather than by consumers," Mr. Miller told the audience of industry executives. "You cannot run your business on the basis that discounts will sell your wine. You can get a comparable boost in sales with displays as you can with discounts."

Wineries have to discount their wines because of an "enormous" amount of inventory and number of labels passing through a few major distribution channels, he said. Less of that discount has made it to the shelf in the past two or three years, but that could change as retailers try to compete with each other over hot brands such as Charles Shaw, aka Two-Buck Chuck, he added.

"The economy shook out infrequent buyers, especially in the $50-plus segment. But I think core buyers of $30-$50 wines have maintained their purchases and are buying more for home," Mr. Miller said.

Mr. Motto projects that the luxury wine market will continue to grow and foster more luxury producers. However, the most frequent buyers of wine are also the nation's fastest growing demographic -- those age 60 and older. Only 4% of respondents to MKF's survey in that group said they bought $30-$50 wines, and none said they bought more expensive wines.

MKF is the leading firm of wine business advisors, providing business consulting, industry research, and CPA services to the owners and managers of hundreds of wineries and vineyards. MKF has served the premium wine industry exclusively for over twenty years.

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