THE MKF ADVISOR

WINE BUSINESS UPDATE

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The Diverging Wine Market

By Vic Motto

As wine sales continue to grow in the U.S., two very different markets are emerging above and below the retail price of around $15 per bottle. As these markets diverge, winery business models are changing to meet the unique needs of each market.

Above $15 is the fine wine market with niche products that are not as widely distributed. They tend to be sold more in restaurants and wine shops rather than in chains—particularly wines above $30. Here, the consumer is generally more sophisticated, has more product knowledge, demands a higher degree of service, and is willing to pay for it.

Below $15 are popular-priced wines for the high volume market—everyday wines for most consumers. They're a dependable value and they're distributed everywhere. This high volume segment is very price competitive and very growth-oriented, and the consumer requires less service and less selection.

IMPACT ON BUSINESS MODELS

Traditionally, all wine products in a producer's portfolio were marketed, sold and distributed in a similar way, through the same systems. Today, the two diverging market segments are beginning to change how wineries, distributors, and retailers operate. Some wine companies are more proactive than others in recognizing and responding to these changes.

Above $15, fine wine needs to be distributed to very specifically targeted smaller retail and restaurant accounts that order smaller quantities, order more frequently, need a high level of service, and want to work with sales people with a high level of product knowledge. The margins in this segment will support this level of service.

The difficulty occurs in distribution and account management and in getting a brand in front of the trade buyers. The buying power for fine wines is fragmented among many more restaurants and wine shops than it is for wines under $15. The role of influential wine experts, both in the trade and media, is much greater.

Below $15, the high volume, popular-priced wines need very broad distribution with good merchandising and promotion. The margins in this segment are getting tighter, driven by retail chains that dominate this segment. A producer needs increasingly greater distribution clout to sell in this segment, and the sale usually goes to the most efficient low-cost producer. As these diverging price segments evolve, winery and (eventually) distributor business models will change. In the future, this could lead to lower distributor margins on chain sales due to growing distribution efficiencies in that segment. It could also support or even increase the higher distributor margins above $15 to cover the high costs of hand-selling small quantities of wine with very demanding distribution needs.

The more proactive wineries with broad product lines are developing separate winery sales divisions for each of these major price segments, and sometimes selling through separate distribution companies. In other words, both the winery sales force and the distributors in each of these two broad segments need to be specialists who can effectively serve the unique diverging needs of each price segment. Generally, the more successful the winery, the more they tend to either specialize in a narrow product line, or they divide and manage their product lines separately. With the consolidating distribution system and the tremendous growth potential in volume, revenue and profits, these changes are keys to the future success of the premium wine industry.

—Vic Motto

MKF founding partner and business consultant, Vic Motto serves as a director of several private wineries and as an advisor to wine industry trade groups. He consults with clients on mergers and acquistions and strategic planning.

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MOTTO KRYLA FISHER LLP

—*Kathie O'Dowd*

As an MKF partner, Ms. O'Dowd specializes in financial assurance and business advisory services. She also develops and teaches financial and related training courses for wine industry professionals.

Partner Comment

The tax man cometh! Yes, some things *never* change.

You are undoubtedly aware of the rapid changes occurring in the wine industry as well as the accounting industry. Changes are occurring within MKF too, as we continue to look for ways to better meet the needs of the evolving wine industry. One thing, however, will never change – our commitment to serving our clients.

We intend to organize ourselves in a way that will allow us to ensure that the high standards for accounting and independence are maintained. The structure may change but the service and philosophy won't.

So, as one year wraps up and yet another tax season gets into full swing, we will be here as always, helping our clients with tax planning and assurance services. Some things never change.

The Changing Role of the Winery CEO – Part 1

Balancing Your Portfolio

By Deborah Steinthal

Current wine industry dynamics of increased competition and consolidation are revolutionizing how winery CEOs manage their businesses. It is clear that these changing market dynamics are driving CEOs to use sophisticated tools and adopt new planning practices in order to continue growing during these turbulent times. When his company was facing dramatic transformation due to demanding market forces, General Electric's CEO, Jack Welch, was fond of saying; "*We come to work every day on the razor's edge of a competitive battle.*" Similarly, the winery CEOs who are coming out ahead today are implementing daringly creative growth strategies and exhibiting persistent survival tendencies.

This article is one in a series that describes the *best planning practices* that these industry leaders are implementing in support of their growth strategies.

BALANCING YOUR PORTFOLIO

Why? The challenge of reaching trade through the clutter of thousands of SKUs is daunting. Wineries with a more balanced, focused portfolio typically perform better than their peers and are realizing strong revenue growth and profitability. Examples can be found in single varietal approaches such as Zinfandel or Cabernet; thematic strategies such as vineyard designated Cabernet from a certain terroir, or style, such as a Burgundian portfolio.

According to one prominent retailer, "wineries need to make more consistent quality products and they need to focus on what they do best." Brands with large portfolios that serve everyone cannot possibly meet these requirements. The president of a high-end Sonoma winery recently commented, "We have recognized that we need to stand for something and focus on what we do best. In the last year we have committed considerable effort to reducing our wine portfolio from 18 to 10 of our top performing wines."

How? "Carefully!" says the CEO of small High-end Napa Valley winery. "We have meticulously used both qualitative and quantitative research tools to help us decide which wines should be in national distribution, versus in specialized distribution such as select restaurants, versus in our consumer direct portfolio. We have reduced our portfolio by 35% in size, choosing those wines that most strongly represent the brand."

Competitive third party tastings with wine critics help winery CEOs identify the best wines and uncover the strongest brand attributes. Thoughtful analysis of market opportunities and a volume-to-pricing strategy need to be developed. Consumer focus groups are another research tool that help an executive team validate assumptions about the brand. The portfolio decisions are then driven by the entire executive team, ideally facilitated by the head of marketing and backed by the long-term commitment of the CEO and the Board of Directors.

Driving a consensus on portfolio strategy is only half the battle. Execution is just as important. The CEO needs to ensure that suitable money is allocated to sales and marketing as the brand is repositioned. An equally heavy focus on training and communications programs has to be directed at the sales team, distributor, and trade staff. Since production strategy is critically impacted, attention must be paid to long-term lease contracts and vineyard planting plans. Finally, creative tactics are required for liquidating wines already in inventory that aren't part of the future portfolio. Building brand equity through a more focused portfolio takes several years before you can reap the results of your efforts.

—*Deborah Steinthal*

Ms. Steinthal is a Senior Management Consultant with MKF. As an executive advisor, she helps winery CEOs with strategic thinking, business planning and market strategy.

Post Enron: The New Accounting Environment

By Wendy Petersen

New accounting related laws enacted over the last year, both on a federal and state level, will have a significant impact on the accounting industry. Although most of the changes relate to accounting firms auditing publicly held companies (something MKF does not do), we anticipate that eventually there could be changes to the way all accounting firms do business. We keep a close eye on regulatory changes to existing legislation as well as pending laws so that we can be proactive in interpreting how the changes will affect us and more importantly, how any changes might impact our clients.

FEDERAL

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. The Act applies to publicly held companies and their audit firms. The basic implications of the Act for accountants are:

1. **A Public Company Accounting Oversight Board.** A Board, appointed and overseen by the SEC, will be made up of five full-time members who will oversee and investigate the audits and auditors of public companies, and sanction both firms and individuals for violations of laws, regulations and rules.

2. **New Roles for Audit Committees and Auditors.** The relationship between accounting firms and their publicly held audit clients is different under the new law.

3. **Criminal Penalties and Protection for Whistleblowers.** The law creates tough penalties for those who destroy records, commit securities fraud, and fail to report fraud.

4. **Financial Reporting and Auditing Process Additions.** Issuers of public stock and their auditors must now follow new rules and procedures in connection with the financial reporting and auditing process.

STATE

Six major bills passed in the California Legislature in 2002 that impact the CPA profession effective January 1, 2003 and apply to both public and privately held companies. Resulting changes from state legislation to the CPA profession are:

DOCUMENTATION

Audit documentation must be retained for seven or more years. And all firms—whether they service public or private companies—must have written retention and destruction policies.

AUDITOR COOLING-OFF PERIOD

Similar to the Sarbanes-Oxley Act, CPAs in a position of significant audit responsibility for an SEC client are prohibited from assuming a responsible position with the client for one year after they performed the client's audit.

CALIFORNIA BOARD OF ACCOUNTANCY (CBA) CHANGES

The Board has been expanded to 15 members, eight of whom are not licensed CPAs.

DISCIPLINE

The definition of a "reportable event" has changed. Beginning January 1, 2003, CPAs must report any of the following events to the CBA within 30 days:

- Any restatement of a financial statement by the audit client.
- Any civil settlement, arbitration award against a CPA relating to the practice of public accounting of $30,000 or more.
- Receipt of a notice to a CPA of the initiation of a formal SEC investigation.
- Any SEC notice to a licensee requesting a "Wells Submission."
- The initiation of an investigation by the Public Company Accounting Oversight Board.
- Any civil judgment alleging, among other acts, dishonesty, fraud, or negligence.

COMMISSIONS

CPAs who perform audits and reviews for clients are prohibited from also selling their services or products for a commission to the same clients.

NON-CPA OWNERSHIP

Firms with non-CPA owners are required to give notice to clients that non-CPA owners may perform services now or in the future for the client.

We will continue to keep you apprised of any new legislation and how it could affect the services we provide. I encourage you to call MKF if you have any questions or concerns about accounting changes and how they might apply to your business.

—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.

MKF New Partners

In recognition of their leadership and commitment to the wine industry, we are proud to announce the newest partners of MKF:

- **Karen Coleman**
- **Gordon T. Axton, Jr.**
- **Wendy Petersen**

Please join us in congratulating them on their achievements.

MKF in the News:

Excerpts from *Time*
Global Business/The Wine Trade
by Terry McCarthy, 10-28-02

Who Really Owns That Winery?

Times are tough in the industry, so the big players are growing by gobbling up smaller wineries

...Around the world and especially in the U.S., companies with cash are snapping up wineries that are struggling, and everyone is trying to improve quality so that the wines can command higher prices.

"The excess in grapes will accelerate consolidation — some players will run out of cash," says Jon Moramarco, (President and CEO of Canandaigua Wine, the second largest wine company in the world after E&J Gallo Winery). He paid Sebastiani Vineyards $295 million last year for Turner Road Vintners and half a dozen mass-market brands, boosting capacity at the less expensive end of his business. To add more upmarket brands to the portfolio, he paid Corus Brands $52 million in March 2001 for several wineries and labels, including Columbia Winery's Syrah, which retails at $18.

Other companies have been on a buying spree as well. Gallo surprised the industry last month when in the space of two weeks it bought two respected upmarket wineries: Louis M. Martini of Napa and the brand and inventory of Mirassou Vineyards.

The Wine Group, third largest wine company in the U.S., acquired Glen Ellen and M.G. Vallejo in May from Diageo. Until then, the Wine Group had relied on its Franzia wine-in-a-box brand, which sold in high volume but at a low profit margin. Diageo added Sterling Vineyards — a Napa property that is more upmarket than Glen Ellen or M.G. Vallejo — with its purchase of Seagrams this year.

Foster's Group of Australia bought Napa-based Beringer Blass Wine Estates in 2000 for $1.5 billion, and for the first time last year, the quintessential global beer company sold more wine ($1.04 billion) than beer ($931.9 million). Allied Domecq of Britain, which already owned Clos du Bois in Sonoma as well as wineries in Argentina and New Zealand, last September paid $275 million for Spain's largest wine producer, Bodegas y Bebidas.

Canandaigua's parent, Constellation, has also been on the acquisition trail. In 1999 it acquired Franciscan Estates in Napa, whose bottles sell for $20 and up. Franciscan added Ravenswood and Simi to its higher-end collection last year. Together they sold 2 million cases for $140 million in 2001. More acquisitions are likely for the Franciscan group and Canandaigua.

Sales of what the industry defines as premium wines are increasing even as cheap-wine sales are declining. According to the wine-industry consultancy Motto Kryla Fisher, among wines costing less than $8 a bottle retail, 116 million cases were sold last year for a total of $2.55 billion — a volume decline of 3% from the year before. But among wines that cost more than $15 a bottle, 15 million cases were sold for $2.17 billion — an increase of 9% over 2000. The higher end is where the profits and the growth are to be found. "With high-quality wines, the costs are higher, but they don't rise as fast as profits," says Christian Miller, director of research at Motto Kryla Fisher. And now that consumers' tastes are moving upmarket, wine sellers are rushing to keep up with them...

LUXURY WINE TRENDS ANNUAL CONFERENCE 2003

The Executive Summit for Luxury Wine Producers and Industry Professionals

FEBRUARY 20-21 AT COPIA

An insider's view on the latest trends in the luxury wine segment and a rare opportunity to network with otherwise hard-to-reach top industry wine writers, distributors, retailers and restaurant wine buyers. Featured speakers:

Joshua Greene, *Editor and Publisher of Wine and Spirits*
Mr. Greene critiques and provides in-depth reviews for nearly 7,000 imported and domestic wines each year. His education program provides wine classes to thousands of business, law, hospitality and culinary students.

Peter Morrell, *Chairman of the Morrell Wine Group*
Owner of the top-rated fine wine shop in New York and recognized within the wine trade as an international wine authority and prominent industry spokesman, Mr. Morrell hosted a radio talk show and has appeared on CNN, NBC, CBS and ABC, as well as the Television Food Network.

Evan Goldstein, *Master Sommelier and Director of Wine and Hospitality Education for Allied Domecq Wines USA*
As one of only 51 Master Sommeliers in the United States, Mr. Goldstein is responsible for the company's educational programs: restaurant and on-premise outlets, distributors, employees and retail.

Richard Driscoll, *Executive Vice President, Sales and Marketing, Winebow Wholesale*
Mr. Driscoll was a retail fine wine buyer and was Assistant General Manager of the Manor Restaurant in West Orange, NJ prior to joining Winebow.

Don't miss this event! Register today, call 707-963-9222 or e-mail: lanthony@mkf.com

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.

For more information, please call Lisa Anthony, Director of Marketing: 707-967-5322 or e-mail lanthony@mkf.com

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