

# **MKF RESEARCH**

## **ASSESSMENT OF THE PROFITABILITY AND VIABILITY OF VIRGINIA WINERIES**

**PRESENTED TO THE SECRETARY OF  
AGRICULTURE AND FORESTRY OF VIRGINIA**

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a division of  
**Frank, Rimerman + Co. LLP CPAs**

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# ASSESSMENT OF THE PROFITABILITY AND VIABILITY OF VIRGINIA WINERIES

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## EXECUTIVE SUMMARY

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At the current time, we believe a majority of Virginia wineries are profitable and viable. In fact, based on our limited but representative sample, over 50% of wineries in Virginia could be considered viable.

There are many reasons to be optimistic in evaluating the future potential viability of these businesses. There has been a rising demand for wine among US consumers over the last several years. Positive factors include changing demographics favoring wine, health issues and a rise in preference for premium products at all income levels. In Virginia alone, wine consumption has increased 3.6% from 2004 to 2005 and 22% since 2000. Wine quality continues to improve in all areas with better access to technology and expertise. In Virginia, the increasing number of wineries is a positive development for the industry, as a growing concentration of wineries tends to attract more visitors and more suppliers to the community. The identification of varietals that perform particularly well in Virginia such as Viognier and Cabernet Franc has helped to carve out a wine identity for the state. Virginia is being recognized in the national media for the quality of its wines. Additionally, many wineries in Virginia are being run very well as businesses.

However, there are also reasons to be concerned. The loss of winery self distribution to retailers and restaurants was a significant blow to the profitability of smaller wineries in the state. Although there are some ways around this issue, it still has created a large negative effect on the industry. Furthermore, if Virginia wineries also lose the ability to sell direct to consumers, there may be few options to keep small wineries profitable and viable.

Some wineries are concerned about county use permits and related restrictions placed on wineries which could impact volume of business, but this seems to impact only certain communities. While nearly all, if not all, of the wineries contacted depend significantly on visitors for their survival, there may be a question about the relative scale of winery versus hospitality activities for some wineries.

There are definitely some wineries which are currently struggling, some of which are up for sale.

There also appears to be limited expertise, especially among some of the smaller wineries, in the financial and capital requirements of operating a winery and in developing sufficient business and financial plans. This is not surprising, given the relative short history of Virginia's modern wine industry, and is not unusual among the emerging wine industries we have seen around the country. The limited expertise is reflected as perhaps over-diversification of varietals and in location decisions which often and understandably grew out of long term land ownership and the complexity of the wine market. Many of these issues can be remedied over time.

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## OBJECTIVES

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The objectives of this report, in accordance with HB1435, are to perform the following:

- Assess the profitability of farm wineries;
- Assess industry trends in profitability and other factors critical to profitability; and
- Assess current marketing and promotional efforts in Virginia.

In order to meet these objectives, we interviewed many individuals involved in the Virginia wine industry. These individuals included winery owners/general managers, vineyard owners and managers, state government personnel and members of Virginia vineyard and winery organizations.

This report was prepared under contract to the Secretary of Agriculture and Forestry of Virginia.

## MEASURING PROFITABILITY AND VIABILITY

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There are many ways to objectively measure profitability of a winery, while viability is highly subjective. Three primary business ratios used to measure and assess profitability were gross margin, return on sales and return on assets.

### **Gross Margin**

Gross margin represents what is left over after subtracting direct and indirect production costs (or costs of goods sold) from sales revenue. It is typically reported as a percentage and profitable wineries generally have at least a 50% gross margin. Larger wineries with economies of scale can still thrive with margins below 50%. Margins in excess of 60% are not uncommon when a significant portion of wine sales are sold direct to consumer.

### **Net Income/Loss**

Net income/loss represents the gross margin less all operating expenses (marketing and administrative) and other expenses (interest and taxes). This amount divided by total sales provides the return on sales. A business is generally considered profitable if this amount is positive, but successful wineries generally experience a return on sales in excess of 10%, although it is rare to be significantly in excess of 10%.

### **Return on Assets**

Return on assets is the net income or loss divided by total assets. This provides an indication of how hard the assets are working for the business. Underutilized assets will lead to a smaller

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return on assets. Since the wine industry is asset-intensive, these returns are generally small, except when a winery leverages facilities or equipment of other wineries or services.<sup>1</sup>

## FACTORS AFFECTING PROFITABILITY AND VIABILITY

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To assess the overall viability of Virginia wineries, we identified several factors with a direct or indirect impact on profitability and/or viability. These factors have been loosely grouped into the following five categories: general business, operations, distribution, retail location and cost control.

### General Business

General business factors which tend to correlate with the profitability and viability (or lack thereof) of Virginia wineries include:

- Capitalization;
- Professionalism;
- Business planning;
- Business focus; and
- Recordkeeping.

#### *Capitalization*

*Capitalization* refers to the contributed and available capital for the business to meet future obligations, expand the business or improve existing assets. The wine industry is extremely capital-intensive between the vineyard, winery facility and equipment, barrels and inventory. Although virtual wineries (wineries without a vineyard or production facility) can be successful in certain circumstances, this is generally not an option in Virginia due to a limitation on custom crush activities. Viable wineries tend to be well-capitalized and wineries which are poorly capitalized will undoubtedly have difficulty achieving future profitability, lacking the working capital to survive the long period needed to produce and sell wine and also lacking the capital to adequately develop facilities, hire staff and grow while developing positive cash flow.

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<sup>1</sup> Such leveraging is typical of what is called ‘custom crush’ in the wine industry, where wineries contract out most phases of the winemaking process to a third party winery and winemaking consultant and may also buy their grapes from independent growers, while retaining control over the winemaking style, sales and marketing and business affairs. Such custom crush activities have grown rapidly and allow new entrants into the industry with less onerous capital commitments.

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## *Professionalism*

When looking for a common characteristic of viable wineries, *professionalism* is a trait that is found in most of the wineries we would characterize as viable. Treating the winery as a professional business and not just a hobby or something done for fun is very important to the success of that business.

## *Business Planning*

While it is important to treat the winery as a business and act in a professional manner, *business planning* is just as important, if not more so. With the long-term nature of the business, evidenced by the long period of time (as long as seven years) from planting a vineyard or even harvesting the grapes and the final sale of the finished bottled wine, successful and profitable wineries must plan well and understand the market into which they are selling. A winery can easily overproduce and ultimately get stuck with excess unsaleable inventory.

## *Business Focus*

Another type of focus that can be lacking is a *business focus*. If the primary focus of a winery is not on the wine itself, but rather the venue or special events held at the winery, the viability of the winery business could be questionable, even if the overall business is prospering.

## *Recordkeeping*

Finally, the quality of *recordkeeping* is generally a good indication of how well the winery is run. Quality information allows the owners and managers to make better business decisions. Several wineries we visited had no idea of the cost to produce their wines. While this calculation can be quite complex, and thus difficult for many wineries, even just a rudimentary understanding of costs is important to manage the business effectively.

Factors affecting profitability		What profitable wineries do	What unprofitable wineries do
General Business	Capitalization	Well capitalized	Undercapitalized
	Professionalism	Run the winery like a business	Run the winery like a hobby
	Business planning	Develop and follow a business plan	No business plan or not followed
	Winery business focus	Run the winery like a business, potentially enhancing other related businesses	See the winery as an ancillary activity to attract customers
	Recordkeeping	Maintain adequate financial records to enhance decision making	Do not have an understanding of costs

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## Operations

Operational factors affecting winery profitability and viability include facility maintenance, supply chain management, varietal focus and asset utilization.

### *Facility Maintenance*

The first thing a customer notices when visiting a winery is the degree of *facility maintenance* and upkeep. In this and most other operations, a poorly maintained facility tends to suggest poor management. A facility which has been allowed to deteriorate is a particular negative for retail operations such as Virginia's wineries. The capital-intensive nature of the industry does not just apply to the initial purchase of a building or equipment, but also to the ongoing maintenance.

### *Supply Chain Management*

*Supply chain management* is a phrase used in other industries for many years, but is still in its infancy in the wine industry. In this case, we are referring to managing a winery's entire chain of supply and demand – it is actually business process management to match supply and demand most efficiently. Examples of how some wineries have been particularly successful in this respect include just-in-time bottling, streamlining logistical steps in the winemaking process and centralizing facilities.

### *Varietal Focus*

A common factor in many struggling wineries around the country is the lack of a *varietal focus*. Ten varietals planted on ten acres may allow the winery to produce many different wines for a broad set of customers, but make it difficult for the winery to concentrate limited resources, to develop focused expertise or define a clear marketing image. Consumers may have a number of alternatives to choose from, but if few are well-made, the consumers will ultimately be disappointed and go elsewhere. Generally, a better strategy is to produce fewer varietals and make them well. This is where intensified local research and consulting services can help wineries identify which varietals may do well in particular areas.

### *Asset Utilization*

Given the industry's significant investment in assets, it is important to make the most out of the assets a winery owns through *asset utilization*. Two examples of ways Virginia wineries have increased asset utilization to increase profitability include utilizing excess production capacity to produce private label bottlings for other wineries or using a mobile bottling line instead of purchasing a costly bottling line for a process that is performed few times during the year.

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Factors affecting profitability		What profitable wineries do	What unprofitable wineries do
Operations	Facility maintenance	Maintain and repair assets as required	Lets facilities or vineyards fall into disrepair
	Supply chain management	Manage supply to meet demand	Produce quantities and then hope to sell it all
	Varietal focus	Specialize in certain varietals	Plant too many varietals and produces too many wines
	Asset utilization	Utilize excess capacity to produce private label wines	Purchases equipment which is not used optimally

## Distribution

Factors affecting winery profitability and viability with regard to sales and distribution include three tier distribution, wine clubs/mailling lists, self distribution and reliance on festivals.

### *Three-Tier Distribution*

*Three tier distribution* consists of a winery selling through a wholesaler to a retailer/restaurant and is the mandated method of distribution to retailers in many states, including Virginia as of June, 2006. Selling through the three tier system can be expensive: wineries typically sell to a distributor for 50% of the price at which the wine is finally sold by the retailer. When selling direct to the consumer, the winery is able to sell at this full retail price. When selling direct to a retailer (self-distribution), the winery may sell at 65% to 80% of the final retail price. In general, since the distribution process itself can be an expensive process when trying to reach a large number of retailers, larger wineries must utilize wholesalers to get a substantial share of their products into the wider marketplace. Smaller wineries often cannot afford to receive as little as 50% of retail price for their wines to have them distributed to local retailers and restaurants and they generally do not produce enough volume to be distributed into the wider marketplace.

### *Self Distribution*

The ability for Virginia wineries to *self distribute* wine to retailers and restaurants was taken away in June, 2006 and has inhibited sales and revenues for several smaller wineries. Smaller wineries often do not attract much attention from wholesale organizations. Self-distribution also allowed wineries to build direct relationships with retailers and restaurants. Unfortunately, some of these relationships have been strained with the introduction of a wholesaler to the process. In many cases, the winery still maintains the relationship – and the marketing costs of the relationship - with local retailers and restaurants while still fully compensating wholesaler for just handling physical distribution.

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## *Wine Club or Mailing List*

We were surprised to find only a small number of wineries with an active *wine club* or a customer *mailing list*, despite often large numbers of winery visitors. Direct communication with consumers is critical to ensure a steady stream of high margin direct sales to consumers. Wine clubs allow for continuing sales from committed customers to supplement their visits to the winery. Every winery should be developing a wine club if they don't have one. The cost to manage the club is easily recouped by the additional high margin income from a steady flow of repeat business.

## *Wine Festivals*

Historically, many Virginia wineries have relied on wine *festivals* as a way to sell their wine direct to consumers. Unfortunately, the increase in the number of wineries in recent years has increased the competition for inclusion in festivals. Some festivals include more wineries, making it more difficult for wineries to differentiate themselves. Thus, festivals have become less productive revenue sources for many wineries.

Factors affecting profitability		What profitable wineries do	What unprofitable wineries do
Distribution	Three tier distribution	Use distributors to reach large retail network, if cost beneficial	Use distributors to sell wine when not cost beneficial
	Wine clubs/mailling lists	Establish wine club	Don't develop direct relationships with customers
	Self distribution	Adhere to law by establishing own wholesaler	Sell at a lower cost through wholesalers
	Reliance on festivals	Participate in beneficial festivals	Don't take advantage of festivals

## **Retail Location**

A winery's retail presence can affect its profitability and viability through the physical location of the tasting room, satellite retail operations, concentration of wineries and county use permits.

### *Tasting Room Location*

The physical location of the *tasting room* can make a significant difference in visitor numbers. Wineries located near tourist attractions or highly traveled roads have a significant competitive advantage. Many wineries are located at the site of the related vineyard due to convenience or cost, but the tradeoff is that they may require the visitor to travel well off the beaten path or that significant marketing costs may need to be incurred to attract customers.























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## Virginia Winery Profitability Study Winery Interview Information Request

12/31/05 or most recent annual financial statements, including:

- Balance Sheet
- Income Statement
- Trial Balance

Projections for 2006 and beyond

Sales information:

2005 and 2006 Case and \$ Sales

- by major product (how long does it take to sell through a vintage of each wine)

- by sales channel (wholesale, retail, tasting room, wine club)

- Do you use a broker or marketing company to manage wholesalers?

- What in-state wholesalers do you use?

- Can you estimate % of wholesale business on-premise vs. off-premise?

- What % is sold in VA?

- Do you self-distribute to retailers?

- Do you sell to ABC stores?

Non-wine sales (merchandise, etc.)

Grape sales

Bulk wine sales

Inventory information:

12/31/05 inventory on hand by product

Cost per case of each product

Current retail price list

Production costs:

Grape costs (per varietal)

- Purchased grapes - cost per ton

- Grown grapes - farming costs per acre/ton

Winemaking costs (including overhead allocations)

Bottling costs (including labor)

Expenses:

Payroll costs and headcount by department (retail, vineyard, production, sales, admin)

Selling vs. administrative (identifying major sub-accounts)

Tasting room

Wine club

Events

What types of marketing do you employ?

How are you affected by the association and tourist board's promotional efforts?

Assets:

Fixed Asset detail

- Vineyard

- Winery

Financing:

Debt vs. equity

Annual debt service

