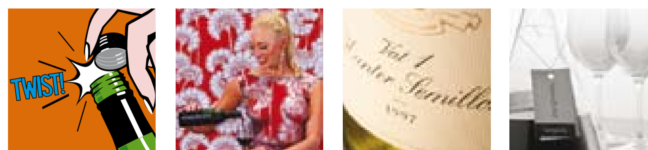
WINE AUSTRALIA: DIRECTIONS TO 2025



BENCHMARKING GUIDE

SMALL WINE BUSINESS

Australian Government

Australian Wine and Brandy Corporation

wfa Winemakers' Federation of Australia

For the Industry by the Industry

Introduction

This guide is one of three that has been developed as part of the '*Wine Australia: Directions to 2025*' project. The joint Winemakers' Federation of Australia (WFA) and Australian Wine and Brandy Corporation (AWBC) project management team, in conjunction with Deloitte Touche Tohmatsu, have developed these guides and a Gross Margin Ready Reckoner (Ready Reckoner).

This guide has been developed with the focus on small wine businesses. For the purposes of this guide a small wine business is defined to have the following characteristics:

- typically owner operator businesses, although some businesses of this size are owned by investors or professionals who contract the wine production and vineyard management;
- wine sales of less than 50,000 cases and up to $5 million case sales revenue;
- it does not incorporate other revenue such as merchandise sales at cellar door, sales of grapes and bulk wine and income from contract processing and packaging, unless specifically identified;
- production capacity of less than 750 tonnes; and
- the business owns/controls its wine making facility and has a combination of estate vineyards and contracted grape purchases.

The subset of this group with case sales of less than $1 million are defined as Micro Wine Businesses.

Wine businesses outside these specific parameters may also benefit from the information and examples provided in this guide.

The objective of the guide is to present information that wine businesses can analyse to identify potential areas where they could improve their businesses, and to assist with the development of sustainable business plans that will meet the challenges of an ever changing domestic and global beverage market.

The financial information presented is based on the results of the Deloitte/WFA Annual financial benchmarking survey for the Australian wine industry (**Wine Survey**) and other wine industry research. Judgements are based on industry best practice and are presented regarding sustainable performance levels for small wine businesses. These judgements are the view of the authors with overview from wine industry practitioners. The 'Best Performing' wine businesses are the top 25% for the small wine business category.

This guide is intended to be used in conjunction with the **Ready Reckoner**. The objective of this model is to utilise the information available to the industry to provide wine business operators with a tool that will assist them with pricing and gross margin analysis.

Finally, it is very difficult to achieve consistency across publications and industry commentary with respect to terminology used to describe retail price points, particularly when comparing across different markets. It is also recognised the categories may overlap to some extent. For the purposes of these Benchmarking Guides, the following terminology and price point comparisons are used:

Retail price point terminology

	Australia AUD/750ml	United Kingdom GBP/750ml	United States USD/750ml
Luxury	>50	>30	> 50
Ultra premium	25-50	15-30	20-50
Super premium	15-25	9-15	14-20
Premium	10-15	6-9	9-14
Popular	5-10	3-6	5-9
Basic	<5	<3	<5
Cask/jug ~4 litre	10-12	n/a	6-9

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1. Executive summary

The objective of this guide is to present information that wine businesses can analyse to identify potential areas where they could improve their operations.

Judgements are based on industry best practice and are presented regarding sustainable performance levels for small wine businesses. The 'Best Performing' are the top 25% for the small wine business category.

Sustainable small wine businesses

Annual revenue	$0-1m best	$1-5m best	Sustainable
Sales	100%	100%	100%
Cost of goods sold	46%	48%	50%
Gross margin	54%	52%	50%
Sales and marketing expenses	8%	16%	15%
General and admininistration expenses	12%	13%	15%
Earnings before interest and tax	34%	23%	20%
Interest	2%	5%	5%
Earnings Before Tax	32%	18%	15%

A sustainable small wine business should return an Earning Before Tax (EBT) margin (as a proportion of revenue) of at least 15% and more likely 20% in order to provide the owners with an appropriate return on investment and also to provide a sound basis for sustainable future growth.

Long term sustainability with a return on investment of at least 15% would indicate that small wine businesses must target a minimum gross margin of 50% of case sales revenue.

Included below are examples of strategies employed by the best performing small wine business. Further details of each strategy and general commentary on other areas of a small wine business are discussed in the body of this report.

Sales & distribution

The best performing small wine businesses generally focus on the following items in terms of sales and distribution to achieve the minimum gross margin of 50%, with varying emphasis on different aspects depending on the individual nature of the business:

- identification and targeting appropriate price points;
- realistic expectation of sales volumes at various price points;
- matching of price points and marketing strategy with brands;
- selecting the appropriate sales channels for each brand;
- maximising the return on dollars spent on sales and marketing support; and
- utilising additional income sources to supplement revenue and profitability.

Sales channels

Direct Sales (cellar door/website/mail-order/local restaurants) are usually the most profitable sales channel for small wine businesses as they retain maximum margin.

The domestic distributor route to market has become more profitable since the amendments to the Wine Equalisation Tax (WET) rebate rules in 2004 and again in 2006.

Sales and marketing

The best performing wine businesses generally focus on the following sales and marketing activities:

- careful matching of the type of marketing spend to the wine price point;
- maximising local advertising opportunities;
- presentation of wines at wine shows;
- targeting wine writers with specific preferences aligned to their wine styles; and
- appropriate use of wine samples.

Additional income sources

Three examples of other income sources which have proved profitable to some of Australia's best performing small wine businesses are:

- contract processing;
- maximisation of the WET rebate; and
- merchandise revenue.

Cost of goods sold and inventory

Many small wine businesses do not correctly evaluate the true cost of producing wine.

Processing costs should capture all wine related costs including labour, overheads and depreciation. Exclusion of depreciation (due to a fully depreciated wine business) and other capital costs provides an artificially low assessment that, for example, does not adequately allow for machinery replacement costs.

It is also important that in determining the real cost of wine production a key component includes a salary allowance for owner or family involvement in the business equivalent to that of comparable staff costs.

Many small wine businesses produce high quality wine which is oak fermented. The significant cost of oak barrels and associated depreciation is often not apportioned to the cost of goods sold.

Full absorption costing should be adopted to more clearly reflect the true costs of wine production and provide more accurate information on which to base sales decisions.

General and administrative costs

For small wine businesses that outsource professional services such as preparation or review of financial statements, tax returns and legal documents, it may be more cost effective to work with similar wine businesses in the region and approach an external service provider on a group basis.

This group approach can also be used by small winemakers to purchase supplies (such as glass) or other business inputs at better prices than may be available to individual companies.

Balance sheet structure

The working capital needs of any business are driven by many factors, including profitability, balance sheet structure, growth and seasonality and timing of material cash flows. The success of any wine business is dependent on many factors, in particular the careful management of the working capital needs of the business. The impacts of working capital management on a wine business are discussed in this section of the guide.

Examples of key areas in which the best performing small wine businesses structure their business and minimise costs are:

Debt

Small wine businesses often have a relatively high level of equity which is understated as owners can be required to use assets as security for debt. Banks may be unwilling to lend to smaller wine businesses without provision of additional assets as security for the debt. Large wineries may be able to secure higher levels of unsecured debt funding from banks.

Working capital

The decision to grow revenue through increased sales or targeting higher price points must be made in full knowledge of the Working Capital to Sales ratio for any business. Small wine businesses with a ratio in the order of 1.13 – 1.22 : 1 will require approximately $600,000 in additional working capital to grow sales by $500,000.

‘Ownership’ of infrastructure assets

Wine businesses expand from micro to small using a variety of growth strategies. Based on the **Wine Survey** and industry experience, the best performing micro and small businesses generally own their own vineyards and production facilities but have used third party grape growers and contract processing as catalysts for growth.

Sale and leaseback transactions

There has been an observed increase in sale and leaseback transactions for small wine businesses, particularly in relation to vineyards. This involves operators selling and then leasing back assets thereby maintaining a strong level of quality control by having employees in place at the vineyard. The benefit for the operator is to free up capital for business development and expansion.

Use of partnerships and joint ventures

Such an arrangement may facilitate the expansion of a small wine business or address unused capacity if it exists. A vineyard owner and wine business operator may be different enterprises through such investment strategies.

The appropriate structuring of the business will assist small wine businesses in achieving sustainable profit levels.

2. Sustainable small wine business

Small wine businesses should target a gross margin of at least 50% of case sales revenue.

The following table indicates the current financial performance of the best small wine businesses and a suggested 'sustainable performance'.

Table 1: Sustainable small wine business (2005 **Wine Survey**)

Annual Revenue	$0-1m Best	$1-5m Best	Sustainable
Sales	100%	100%	100%
Cost of goods sold	46%	48%	50%
Gross margin	54%	52%	50%
Sales and marketing expenses	8%	16%	15%
General and administration expenses	12%	13%	15%
Earnings before interest and tax	34%	23%	20%
Interest	2%	5%	5%
Earnings Before Tax	32%	18%	15%

1. The figures have been adjusted to include branded wine only and are presented as percentages relative to total bottled wine sales revenue
2. Modified to aggregate other non-operating income /expenses with Administration expenses

The best performing wine businesses up to $1 million in case sales revenue are returning Earnings Before Tax (EBT) in excess of 30% and those between $1 million and $5 million more than 15%.

A sustainable small wine business should target an Earning Before Tax (EBT) margin (as a proportion of revenue) of at least 15% and more likely 20% in order to provide the owners with an appropriate return on investment and also to provide a sound basis for sustainable future growth.

Long term sustainability with a return on investment of at least 15% would indicate that small wine businesses must target a minimum gross margin of 50% of case sales revenue.

Various components that contribute to a sustainable small winery business are discussed in the following sections.

The 50% sustainable gross margin level is the **minimum** required to provide **Earnings Before Tax** (EBT) of 15% based upon the following assumptions:

- **sales and marketing expenses** of 15% of revenue;
- **general and administration expenses** of 15% of case sales revenue; and
- **interest** of 5% of case sales revenue.

The EBT level of 15% assumes the small wine business has already included appropriate salaries for owners who work within the business and also includes sustainable levels of depreciation and interest.

The minimum gross margin of 50% is consistent with that reported by small wine businesses from the **Wine Survey** as shown in the following table and less than that of the best performers:

Table 2: Gross margin (**Wine Survey**)

Wine business sales	Average Gross Margin	Average Gross Margin	Average Gross Margin	Best Performers Gross Margin
	2003	2004	2005	2005
< $1m	46.1%	49.7%	48.7%	53.5%
$1-5m	41.5%	45.7%	49.7%	52.2%

Based upon the **Wine Survey** results, a gross margin in excess of 50% is clearly achievable.

Some improvement in gross margin figures flowed through for small wine businesses from the WET rebate delivered in the 2004, and extended in the 2006, Federal Budget.

The **Ready Reckoner** assumes a sustainable gross margin of 50% for small wine businesses and highlights scenarios that generate gross margins below this level.

Wine Equalisation Tax (WET) rebate

The **Ready Reckoner** identifies the WET rebate. Small wine businesses above the threshold (that is their gross domestic wine revenue is more than $1.725 million), are rebated the maximum $500,000 of WET liability and wine businesses below the $1.725 million will have no net WET liability.

Wine businesses are strongly encouraged to treat the WET rebate as additional income, rather than a component of gross margin and the rebate **should not** be an element in setting prices.

This additional income can provide a further source of funding for activities such as brand building and promotion and other business requirements.

3. Sales and distribution

The best performing wine businesses generally focus on the following items in terms of sales and distribution with varying levels of emphasis:

- identification and targeting appropriate price points;
- realistic expectation of sales volumes at various price points;
- matching of price points and marketing strategy with brands;
- selecting the appropriate sales channels for brands;
- maximising the return on dollars spent on sales and marketing support; and
- utilising additional income sources to supplement revenue and profitability.

Each item is discussed in more detail below.

3.1 Price points

What proportion of wine is sold in each price segment?

The following charts demonstrate that small wine businesses sell the majority of their production at more than $15 per bottle. This is driven by cost structures that make it almost impossible to compete in the lower price points at sustainable levels of gross margin of around 50% of sales revenue.

Chart 1: Revenue by price point ($0-$1 million)

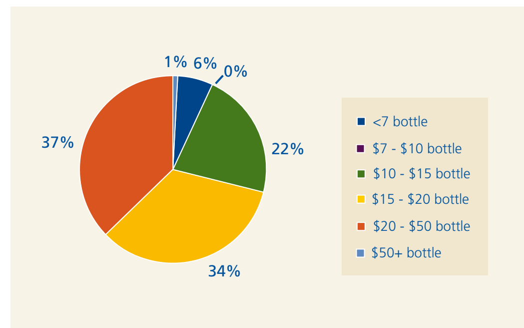
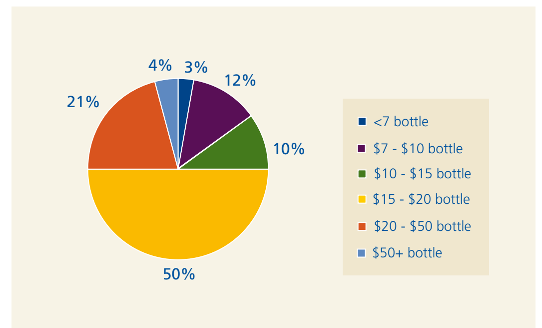


Chart 2: Revenue by price point ($1 million-$5 million)



The charts below show the proportion of wine sold at each price point globally (Chart 3: Rabobank) and the proportion of advertised wine prices in the Australian retail sector (Chart 4: LMA Database).

Chart 3: World wine sales (Rabobank)

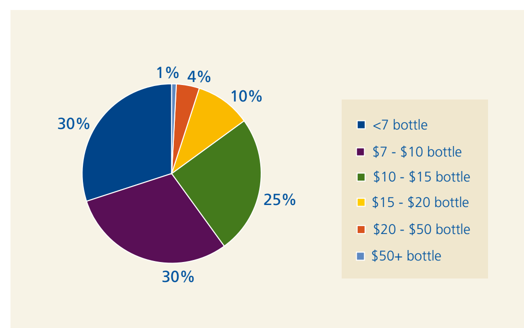
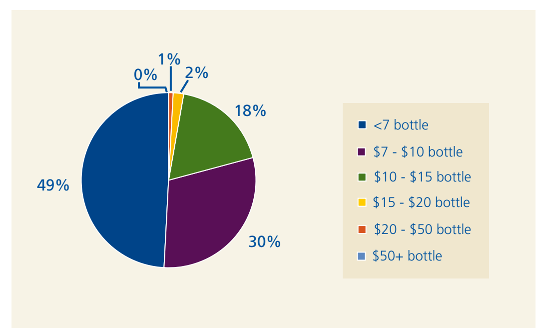


Chart 4: Advertised domestic retail wine prices (LMA database)



The Liquor Merchants Association (LMA) database collects information on advertised wine prices in media throughout Australia and this data provides an indicator of the promotional price points targeted by the retail trade (off-premise).

Small wine businesses will sell a significant proportion of wine in the on-premise market. However, when considering growth of retail (off-premise) opportunities, small wine businesses should be aware that 85% of wine sold globally and more than 95% of wine advertised in Australia is less than $15 per bottle. The barriers of entry and cost efficiencies of the larger wine businesses make it very difficult for small wine businesses to compete in the under $15 per bottle retail market.

What is the impact of selling at high price points?

In moving towards higher price points there is a propensity to trade off higher revenue and margins against a corresponding decrease in number of cases sold.

A pitfall for small wine businesses is to assume significant growth of high priced wine when most wines selling for over $50 per bottle generate annual sales of less than 1,000 cases per year.

3.2 Wine Australia branding

The new branding campaign being rolled out in 2007 for Wine Australia identifies four sub-personalities for wine. The development of these four sub-brands marks a subtle but significant move that still recognises the unifying purpose of Wine Australia as an overall category statement, but at the same time moves beyond a single, 'one-size-fits-all' generic platform.

The four personalities – Brand Champions, Regional Heroes, Generation Next and Landmark Australia – represent the following four value creations respectively: accessibility, interest, innovation and aspiration. Each individual personality has a discrete brand and channel management strategy of its own, but does not restrict a brand or producer to operating in one dimension alone. The refreshed approach acknowledges that to remain relevant and compelling to all of its audiences, a wine category or country has to keep evolving and, as with all component strategies, the ultimate aim is for the sum of the parts to be greater than the whole. Further information on the branding campaign can be found in the **Directions to 2025** document.

The branding strategy goes beyond a linear definition of wine categories using price points alone. For the purposes of this Guide, the terms luxury, ultra premium, super premium, premium, popular and basic will be used as general indicators of price points.

3.3 'Iconic' wines

The term 'Icon' can be interpreted a number of different ways, the guide uses the term 'Luxury' for the price range above $50 per bottle and 'Ultra Premium' for the price range $25-$50 per bottle.

There are limited wine consumers who have the financial capacity to purchase luxury or ultra premium wines. Therefore, the sale of these high priced wines requires a targeted marketing and distribution strategy.

Many of the best performing wine businesses have strong and often long established brands which have been built around the success of certain 'icon' wines which attain the very high price points.

The information from the survey and wine portfolio modelling clearly demonstrates the positive impact on profitability for a small wine business if it develops high quality wines that with focussed marketing can command luxury or ultra premium pricing, after wines that – and after – marketing.

The creation of such strong brands generally takes decades and even then success is not assured. Small wine businesses targeting a luxury or ultra premium wine at significant volumes should consider this as a medium to long term ideal.

3.4 Sales channels

The following charts illustrate the proportion of wine sold through each sales channel by Australia's small wine businesses.

Chart 5: Sales channel ($0-$1 million)

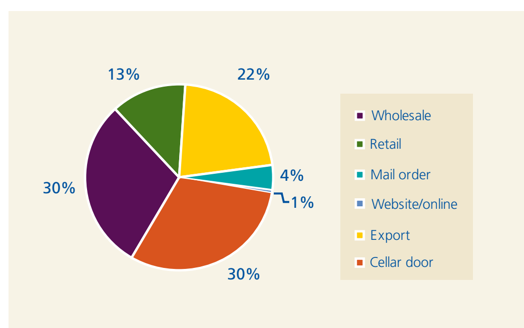
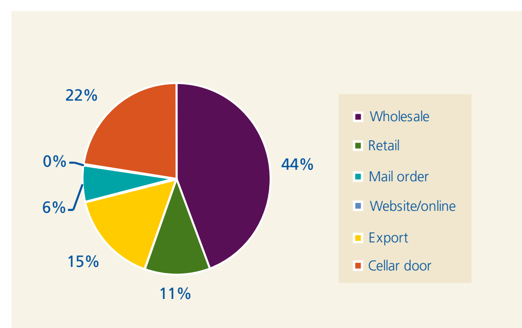


Chart 6: Sales channel ($1 million-$5 million)



Each sales channel should be treated as a profit centre. The quantity of wine sold, and the price and margin the wine business achieves for the same product, is likely to differ for each sales channel. The corresponding risks will also vary and the wine business must manage their risk and sales mix in order to maximise stability and returns. For example, while the use of a distributor may involve no capital outlay, termination of a distribution agreement can result in a lag of 1-2 years to rebuild sales via a new distributor.

Sales channels for small wine businesses have been divided into the three key areas for the purposes of this guide:

- direct sales;
- exports; and
- agent/distributor sales.

A. Direct sales (Cellar door/website/mail-order/local restaurants)

These sales channels are often the most profitable as the wine business retains maximum margin. The way they are presented and managed must reflect the overall brand strategy for the winery.

Cellar door

Establishing a cellar door can involve significant capital outlay and will require ongoing commitment of resources once it is operational. It is therefore important that those wine businesses that have invested in cellar door infrastructure maximise the use of the facility.

Cellar door facilities range from basic to very extravagant; if well managed, most cellar door operations can be valuable to the wine business in terms of sales income, brand building and building a loyal customer base.

However, careful consideration should be given to the motivations for setting up a cellar door facility. Whilst the facility might be simply viewed as an alternative sales outlet for wine, in reality the wine business has entered a new industry – the tourism industry. As such, operators will be expected to provide a range of services and amenities that suit visitors to the region. This is a very different concept from the traditional product-driven approach that the cellar door is simply a public relations opportunity or sales outlet. In this competitive market-driven environment, successful cellar doors require a broad approach to attracting visitors and meeting modern consumer expectations.

Further discussion of the cellar door operations and wine tourism is provided at Section 4.

'Satellite cellar doors'

In Queensland, the State Government has introduced an innovative cellar door concept that is helping to drive the food and wine industry through 'Satellite Cellar Doors'.

The concept allows wineries to open a number of 'satellite cellar doors' away from their winery that are specifically designed around the promotion of the Queensland wine industry. This allows, for example, the sale of wine in conjunction with a butcher, or a bakery or a delicatessen without onerous or cost prohibitive licensing restrictions while maintaining strict access protocols. It also allows for the cellar door facility to be positioned in areas that attract high volumes of tourist or local traffic, which is especially valuable if the production facilities are located in remote areas.

This system offers significant benefits for Queensland wine producers, and businesses operating in other states are encouraged to investigate their licensing provisions and whether their state governments would consider a similar cellar door arrangement.

Website

The Internet provides another avenue for wineries to communicate with consumers and sell products and services. The Internet is becoming increasingly important as a research tool for consumers and visitors and is currently the largest retail vehicle in the world.

For many consumers, a website may be the first direct contact with a winery after purchasing its product in the retail marketplace or when planning a visit. Therefore it is important to get this channel right. This means deciding up front what the purpose of the website will be: brand promotion or direct sales. Many wineries attempt to do both, which can prove unsuccessful as the presentation required to promote the brand versus selling wine is quite different.

Attributes of a promotional site:

- objective is to convey information and build relationships;
- looks and feels like a brochure;
- home page is brand and image rich;
- clearly establishes market positioning; and
- brand story unfolds over several pages.

Attributes of a sales site:

- objective is to sell wine and build qualified customer database;
- focuses heavily on product, price and offer;
- creates an imperative to purchase;
- parameters for purchasing (when, what, how) are clearly defined; and
- wine club membership is strongly promoted.

Website development is a highly specialised and rapidly changing field. Therefore, it is recommended that a qualified web developer is engaged in setting up the website from the beginning. Key aspects that need to be taken into consideration include:

- registration of domain name;
- internet service provider considerations;
- website objectives;
- site navigation;
- visual imagery;
- website content;
- search engine optimisation;
- online purchasing options/security;
- appropriate links;
- website tracking;
- web marketing (such as blogs); and
- links to database.

Further information on website development, including a checklist, is available from the Winemakers' Federation of Australia resource, 'The Wine Tourism Toolkit – A Resource for Australian Wineries' (Marketing & Promotion section) www.wfa.org.au.

Other communication media

SMS – short messaging service – is a new technology that many service providers and retailers utilise to send messages directly to customers' mobile phones. As an example, SMS could be used to send messages to targeted customers about an upcoming release or restaurant promotion in their area. Service providers use this medium successfully to confirm appointments or remind customers of their current membership status.

As with any area relating to collection and use of an individual's information, this approach should be carefully managed to ensure it complies with Privacy Laws and is only used with the express permission of customers.

Mail order and wine clubs

For many wineries the cellar door offers the opportunity to gather qualified leads for their database. However, gathering visitor contact details is insufficient to manage an effective mail order business.

A wine club should not be confused with a mailing list. Most wineries claim to operate a mailing list, however unless the list is maintained and purged regularly, it is unlikely to become a viable source of sales. There is usually little incentive for mailing list customers to remain loyal to the winery and many initially subscribe simply out of obligation when they have failed to make a cellar door purchase. A disciplined approach to the collection of qualified customers is essential with ongoing maintenance to achieve success in this area.

A wine club implies membership and expectations – both on the part of the winery administering the club and the member. Successful wine clubs can achieve comparable sales with other distribution channels, and even exceed them if conducted properly. Many wineries operate this sales outlet as a separate part of the wine business.

Direct mail is a highly specialised sales area and winery operators should seek expert advice before embarking on sales campaigns. Key considerations include:

- Customer Relationship Management (CRM) system capabilities;
- interaction between database and point of sale systems;
- comprehensive customer data forms;
- internal resources required;
- mode and frequency of customer communications;
- choice of sales promotion (periodic or automatic);
- calculation of lifetime value for each customer;
- incentives and membership categories; and
- ability to segment database effectively and document customers' preferences.

Direct to consumer sales via the web or by mail order are an important part of the sales mix and can easily justify the investment in a cellar door facility if operated correctly. Similarly, this is a legitimate avenue for wineries without cellar door facilities to build their brand and achieve retail margins.

The Winemakers' Federation of Australia provides further information on this segment through its 'Wine Tourism Toolkit – A Resource for Australian Wineries' and the WineSkills Business Program. Australia Post also offers comprehensive information for conducting effective direct mail campaigns and direct distribution strategies. Visit www.auspost.com.au for up to date information.

Restaurants (direct to 'on-premise' market)

Wine sold directly to restaurants by wine businesses can deliver strong gross margins and promote the wine in the on-premise market. However, the quantity sold to each restaurateur is normally limited to one case at a time and the wine business generally covers freight charges. The wine business will also have to manage the bad debt risk of potentially a large portfolio of small customers with limited purchases.

The Ready Reckoner is built around the off-premise market. While it is accurate to expect sales through on-premise outlets might deliver a better return for wine businesses than distributor or agent sales, there are additional margins to consider such as a 50%-70% on-premise mark-up when comparing on-premise prices vis-à-vis retail outlets. Direct sales will generally offer the best margins for wine businesses.

A viable option for small wine businesses to consider in dealing with non-local restaurants is to use the services of a 'redistributor'. That is, the winery still deals directly with targeted restaurants but warehouses wine locally with an agent for delivery in the area when cases are sold. For example, an Adelaide Hills wine business selling to Sydney restaurants would use a local Sydney agent to warehouse wine for immediate delivery when sales are confirmed.

There are a number of different options and alternatives for small wine businesses to investigate to capitalise on economies of scale by working with similar businesses in their area.

B. Export

For a limited number of small wine businesses, the export sales channel offers a very profitable route to market. External influences such as a high 'Robert Parker Jnr' (U.S. wine journal, 'The Wine Advocate') rating may significantly enhance this potential by increasing the US demand and price attainable far in excess to that which may be achieved in Australia.

However, in most cases, the export sales channel will not be as profitable as cellar door or direct sales to consumers. While the sales are free of GST and WET, these savings will often be more than offset by importer margin (such as in the US market), distributor margin, retail margin, import duties, taxes and freight costs.

There is also the risk of foreign currency movements if the sales are made in a currency other than AUD.

The **Ready Reckoner** does not use the exchange rate as a basis for determining an AUD equivalent for USD and GBP retail selling prices. It identifies broadly equivalent market price based on common brands in the overseas market.

The **Ready Reckoner** assumes the following margins which are based on benchmarking data and industry norms:

Table 3 – Australian, United States and United Kingdom margins (assumed)

	Australia	United States	United Kingdom
Importer	Nil	33%	Nil
Distributor	30%	30%	33%
Retailer	30%	30%	33%

The three levels applicable for the US market add nearly 125% (being 33% x 30% x 30%) to the wine price.

Wine businesses need to understand the relevant taxes and duties for each country to which they intend to export. For example, the US has federal taxes as well as varying state-by-state taxes.

Similarly, wine sold above 14% alcohol volume in the US attracts USD 0.34 duty per bottle as compared to USD 0.21 for wines under 14% alcohol.

C. Agent/distributor (domestic)

The sale of wine through a distributor to a retailer tends to generate a lower margin per case for the wine business than direct sales due to the distributor and retailer margins.

Offsetting this, the use of a distributor generates only variable costs and involves no fixed costs. The distributor may also provide warehousing facilities for wine storage.

This route to market has become more profitable since the amendments to the WET rebate rules in 2004, extended in 2006. Whereas the rebate previously only applied to cellar door sales, it now applies to the first approximately $1.725 million of domestic sales or a threshold of $500,000 of WET liability.

It is important for the wine business to manage and work closely with their distributors. This may involve monitoring the distributor's performance and discussing concerns as they arise. A close working relationship may encourage additional efforts such as advertised in-store presentations.

A wine business should be aware of all retail price offerings of their products. The retailer may reduce the price of a particular wine to sell any slow-moving product. The availability of wine at a reduced price may discourage customers from purchasing the wine through other sales channels such as cellar door or on-line.

The distributor and retail margins in the **Ready Reckoner** are at Table 3. The actual margin may depend on a number of individual considerations including the volume of product sold through the distributor or retailer.

The effects of discounting

Small wine businesses tend not to trade with the large retail chains and therefore rarely have to provide discounts or rebates.

The financial consequences of selling on promotion are significant, and the **Ready Reckoner** allows the winery to consider this impact on margins by altering price point and retail margin where applicable for comparison against original pricing information.

In most cases, a small wine business selling wine on promotion will have to sell around twice as much wine to achieve the same dollar contribution.

The 'Guide for Large Wine businesses' discusses the challenges and opportunities of selling through major retail chains in greater detail, including discounts and rebates.

3.5 Sales and marketing support

Based on the results from the 'Best Performers' in the **Wine Survey**, the **Ready Reckoner** assumes a sustainable level of sales and marketing expenses of 15% of sales revenue for small wine businesses.

The best performing wine businesses have sales and marketing expenses of around 8% of revenue.

The indication is that these wine businesses have well established brands and it is likely the marketing sales effort and cost invested in previous years has allowed their spend to reduce.

Sales and marketing strategy

Actual sales and marketing costs will vary depending on marketing strategies and the routes to market.

The best performing wine businesses generally focus on the following sales and marketing activities. The structure and magnitude of these activities varies between small, medium and larger wine businesses:

- careful matching of the type of marketing spend to the wine price point;
- maximising local advertising opportunities;
- presentation of wines at wine shows;
- targeting wine writers that are likely to be more sympathic to their wine styles; and
- appropriate use of wine samples.

Each item is discussed in more detail below.

i. Marketing spend for different price points and markets

The type of marketing will depend on the price point.

While marketing for high priced wines should generally involve close contact between winemakers and consumers, the majority of lower price point wine is often sold on promotion through retail chains.

It is estimated that between 60%-80% of high volume lower-priced wine is sold on promotion in the UK. Wines that have attained a quality reputation and command luxury or ultra premium pricing are not generally discounted and their retail promotion (if any) often takes the form of in-store tastings.

ii. Advertising costs

Small wine businesses do not generally invest in expensive commercial television or large print media advertising, but rather devote time and effort towards activities such as in-store tastings and wine shows.

The advertising that is done by small wine businesses is generally local or through contributing to advertising by distributors which may be paid for in the form of commission. Many small wine businesses attend industry events such as Wine Australia and use the many wine shows across the country to try and obtain trophies or medals for their wine.

The development of an advertising/marketing strategy needs to be suitable to the size of the wine company and resources available. A small wine company will often be limited in staff and financial resources and their strategy could include (among other aspects) targeted local exposure. Small wine business operators should ensure their wine is available for purchase at available outlets within their region such as local restaurants and independent retail outlets, regional information centres, regional tourist bureaus and high profile regional events. They also need visibility of their personnel at local events to ensure their wine is receiving as much positive exposure as possible.

iii. Wine shows

Entering wine shows is a choice for each wine business to make. For small wine businesses trying to build brand awareness and improve quality through peer assessment, the wine show circuit is an opportunity that should not be ignored.

It is most likely unrealistic to enter all brands and vintages into wine shows given the associated costs and quality variations. Small wine businesses should therefore target specific wines to shows where they believe they have a realistic chance for success or they are seeking specific feedback from judges.

When a wine is successful, particularly at a gold medal or a trophy level, the small wine business should have a pre-determined strategy to leverage from that victory including immediate media announcements and promotion through customer mail-outs and email distribution lists. Success should be highlighted at all sales opportunities including website, cellar door and restaurant outlets. Media attention will most likely be strongest immediately following the event.

iv. Wine writers

Key wine writers have significant influence in relation to consumers' wine preferences. Wine businesses should target specific wine writers they believe have wine preferences aligned to their products. Contact should be via samples accompanied by notes and an overview of the wine and its target market. Wine writers generally receive such multitudes of wine that it would be impossible to write about all of them. The challenge for small wine businesses is to make the process as simple and easy as possible for writers and target personal contact if possible.

v. Wine samples

One of the key marketing activities for small wine businesses is the use of samples. Many wine companies, particularly small wine companies, overlook the cost of providing samples in their pricing process. It is also critical for wine businesses to have a clear strategy in the use of samples in the marketplace. The marketing strategy should estimate production of each brand and include an analysis of the number of samples, the type of people those samples will be sent to, and the purpose behind sending the samples.

Up to 5% of wine sold each year is in the form of samples provided for tastings or promotions either at cellar door or through distributors and retailers/restaurants in order to gain a listing. Approximately one bottle of wine is used for tasting for every dozen sold at cellar door and wine shows are another significant outlet for samples.

Samples should be accounted for at their equivalent sales value and taken into account as a cost of marketing.

3.6 Additional income sources

Below are three examples of other income sources which have proved profitable to some of Australia's best performing small wine businesses.

A. Contract winemaking for others

Small wine businesses need to consider their most efficient use of capital in assessing whether they will invest in their own winery and equipment or utilise a contract processing facility. Wine businesses that own their own facilities should understand the financial effects of utilising the full capacity of their assets.

Contract winemaking can be a profitable revenue source for some wine businesses, especially those who are well recognised in their region. There is also inherent risk associated with contract processing and the business should distinguish between short-term opportunities to maximise use of excess capacity and long term contracts which may be a more permanent income component of the business.

Providing a contracting service for one or two vintages that utilises short-term excess capacity intended for expanded own production can increase revenue with only a small marginal increase in production costs. It can significantly improve profitability as the additional revenue can be generated often without the need for additional equipment such as tanks or barrels, and incurs little additional labour and overhead. (If barrels are required, it is standard practice for the client to provide the barrels to the contract winery).

This additional income, however, can come at the expense of delivering a competitive advantage to the recipient of services if full costs are not factored into the pricing, including overheads, depreciation and other costs of capital as outlined overleaf.

Example: Contract processing for others

A small winery has excess crushing capacity and has been approached to crush an additional 30 tonnes of shiraz by a local operator.

The local operator has offered to pay $600 per tonne for processing of this small batch and will take delivery of the bulk wine before it is barrel matured for maturation with an independent party.

This service can be considered in two ways.

a) by considering the variable cost of processing the tonnes;

b) by considering the full costs of production including depreciation, overheads and full cost of capital.

If we assume the marginal costs of production are say, $5,000, the extraction rate is 600 litres per tonne and the wine business full absorption cost is $2.00 per litre (source: **Wine Survey**), the winemaker could assess the revenue and costs as follows:

Table 4: Contract processing example

	Variable costing $	Absorption costing $
Revenue	18,000	18,000
Costs	5,000	36,000
Profit/(loss)	13,000	(18,000)

While using the variable costing makes the exercise appear to be lucrative as it will utilise some of the small winery's capacity and deliver incremental revenue far in excess of incremental costs, it will offer the local operator a competitive advantage through cheaper production than could be achieved if they had to invest in their own wine business.

Under the full absorption costing scenario, an extraction rate of 600 litres per tonne will derive 18,000 litres. The fully absorbed cost of processing at $2.00 per litre (source: **Wine Survey**) would be $36,000 and therefore the transaction under full absorption costing is very unprofitable for the small wine business.

In fact, the small wine business would have to charge $1,200 per tonne to break even. This is far above the market rate charged by most small wine businesses and suggests this practice is not sustainable in the long term.

The ultimate decision to accept the proposal will depend on the current utilization of the wine businesses capacity.

For example, if the winery was at 50% capacity, it may make sense to accept the proposal and earn the incremental revenue in the short term as the benefit may exceed the cost of asset utilisation and risk of the competitive advantage provided to the local winemaker.

Alternately, if the wine business was near capacity, the risk may outweigh the benefit.

B. Wine Equalisation Tax (WET)

There are two key aspects to managing WET liability:

- minimising the amount of WET payable by excluding WET exempt items such as samples and freight; and
- maximising the WET rebate available.

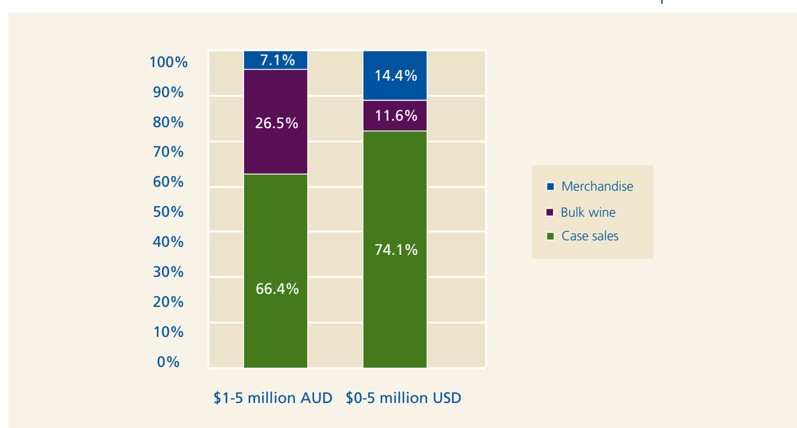
The Federal Producer WET rebate is available for all domestic wine sales and the Government extended the threshold to $500,000 per entity in 2006. This essentially means that wine businesses with domestic sales below $1.725 million wholesale will not have any WET liability.

The WET rebate should be treated as additional income wherever possible and should not be used in pricing considerations. The rebate should be reinvested into the business through marketing and other business development activities rather than used to lower the price point for the product.

The **Ready Reckoner** allows wine businesses to determine the approximate WET payable in relation to each pricing scenario. Wine businesses should seek external advice on how best to maximise the WET rebate available to their business and minimise their WET payable in accordance with the tax law.

C. Merchandise revenue

Chart 7: Revenue sources for small wine businesses – Australia compared to United States



As indicated in the chart, merchandising revenue for small Australian wine businesses is half that of small US wine businesses. In the US, sales of T-shirts, wine glasses, corkscrews and other items generate almost 15% of revenues of small wine businesses.

Australian wine businesses with less than $1million of revenue generated less than 1% of revenue from merchandise sales.

The merchandising revenue segment tends to have a low cost of sales and high margin, often with a 100% or 200% mark-up on cost.

Insight:

Small wine businesses should consider sales of more than just wine to cellar door visitors. International visitors in particular have demonstrated demand for Australian branded items and merchandise could also be available on-line or via mail order. It is the total experience at cellar door that the customer takes away with them and a positive experience drives loyalty and repeat purchases.

4. Understanding the tourism industry

For small wineries in particular, tourism can often be the mainstay of the business environment and financial returns.

Wine Tourism is simply another sector of the broader tourism industry and is subject to the same distribution channels, controlling organisations and seasonal variations as other tourism sectors. There is abundant research available that segments different types of tourists and analyses their behaviour. It is essential that cellar door operators understand visitor motivations, because these can be quite different to regular wine consumers. The information gained from such research can be used to determine the range of facilities and services to offer and how to reach specific target markets.

It is also necessary to understand how the tourism industry works in order to effectively use available resources, as there are various promotional programs that cellar doors can participate in – either with private commercial tourism partners or the regional and state organisations.

Tourism Australia, the statutory body for tourism in Australia, is primarily responsible for marketing Australia internationally and also has a domestic charter. Its research arm, Tourism Research Australia, administers various programs including national and international visitor surveys and produces market reports to aid each tourism sector. The State Tourism Organisations (STOs) are responsible for marketing each state domestically and internationally and provide specialised services for the various sectors, including Wine and Food. Regional Tourism Organisations (RTOs) provide local marketing and promotion for their regions and are therefore a key partner for cellar doors.

4.1 The business of wine tourism

Some of the benefits associated with offering a cellar door facility include:

- higher profit margins through direct to consumer sales;
- access to new market segments;
- the opportunity to 'test market' new products;
- collection of consumer and market intelligence;
- diversification and revenues from additional products and services; and
- brand building and public relations opportunities.

The cornerstone of a successful cellar door is the ability to provide tangible experiences that visitors are willing to pay for – either directly or through increased product sales. To achieve this outcome, a cellar door business plan is essential. The plan should address several key areas, including:

- strategy – brand, image, point of difference;
- location – tourist route, seasonality, destination;
- presentation– structure, function, entry, facilities, amenities, ambience;
- experiences – tastings, tours, food, products; and
- people – hospitality, sales, service, knowledge.

Each of these is discussed below.

i. Formulate a strategy

Before building a cellar door facility, winery operators need to undertake market research to determine the range of facilities and services to offer and identify target markets. This process should include a detailed competitor analysis, identification of any market gaps, potential tourism partners and promotional opportunities. It is vital to establish a unique point of difference that reflects and complements the winery's brand values, while positioning the cellar door as a credible regional attraction in its own right.

ii. Ideal location

It is important for wineries to understand the potential impact that their physical location has on their ability to attract sufficient numbers of visitors. By undertaking a regional audit, wineries can identify factors such as proximity to tourist routes and townships, major attractions, ideal locations for directional signage, seasonal variations, location and frequency of regional events, visitor centres and other service providers. This information can be used to position the cellar door effectively within the region (if possible) or maximise the existing property's attributes through effective signage and promotion.

iii. Effective presentation

Irrespective of budget constraints, cellar door presentation should reflect the winery's brand image and have the ability to attract the target market/s. Consideration should be given to environmental impacts, signage, functionality, accessibility, ambience, layout, amenities and facilities.

iv. Tourism experiences

The range of products and services offered should be congruent with the winery's brand objectives and satisfy visitor expectations. Options include varied tasting formats, winery and vineyard tours, interactive displays, provision of food options, entertainment, education and even accommodation or lifestyle services. Merchandise sales can encompass clothing, wine related accessories, lifestyle products, local produce, arts, crafts and more.

The most significant benefit to be gained from a well managed cellar door that attracts sufficient visitors is direct interaction with existing and potential customers. It is essential that this interaction is maximised to full advantage by providing worthwhile and positive experiences, eliciting sales from the visit and developing post-visit sales through direct, ongoing contact.

v. People skills

The most critical element of the cellar door experience is the ability of front line staff to create a positive outcome for every visitor. Ultimately, it is the personal interaction between staff and visitors that will create a lasting impression – well beyond fancy infrastructure and quality wine. Therefore, cellar door proprietors should invest in attracting and retaining the right mix of staff that meet a specific set of skills criteria.

4.2 Barriers to cellar door sales

There are several factors that influence the ability of cellar door staff to convert visits to sales. These include:

- sales ability – the individual ability of cellar door staff to proactively sell products and services;
- price competitiveness – comparative pricing with the winery's brands sold through retail channels and the effects of mass discounting;
- transport arrangements – the ease by which visitors can transport wine purchases home (domestic and international); and
- ongoing availability – mail order or wine club facilities and metropolitan retail outlets.

The cellar door represents a valuable opportunity for wineries to expand their customer base, sell wine direct to visitors and create ongoing consumer relationships.

Comprehensive wine tourism resources are available from the Winemakers' Federation of Australia at www.wfa.org.au that cover areas such as:

- business planning;
- cellar door operations;
- research;
- cellar door infrastructure & facilities;
- marketing & promotion;
- training & development;
- products & services;
- domestic tourism; and
- inbound tourism.

Resources available include:

- 'Your Guide to Wine Tourism' fact sheets;
- 'Wine Tourism Uncorked: A guide to making wine tourism work for you' booklet;
- 'The Wine Tourism Toolkit: A Resource for Australian Wineries' CD;
- Wine Tourism Research & Publications Database;
- Business Services for Wine Tourism; and
- Cellar Door Benchmarking Program.

The Winemakers' Federation of Australia conducts tailored wine tourism workshops covering the tools and information listed on demand in regions.

5. Cost of goods sold and inventory

The following section details the components of each case of wine as presented in the Ready Reckoner and provides insights into management of inventory levels.

5.1 Absorption costing

This guide is compiled on the basis of adopting full absorption costing. Full absorption costing requires all costs associated with the manufacture of inventory to be capitalised into the cost of inventory and not included as period costs in general and administration expenses.

Examples of the types of costs which are often expensed and not capitalised into inventory include:

- depreciation of plant and equipment;
- winemakers' salaries;
- other direct salaries;
- amortisation/depreciation of oak barrels;
- light and power for winery; and
- laboratory costs.

These are all costs of the manufacture of wine and should be included in the calculation of inventory and cost of goods sold.

It is important for a wine business to clearly differentiate between the accounting treatment for costs of production and the taxation treatment for these costs. The treatment may be quite different and can result in an inaccurate assessment of costs and an incorrect targeting of price points.

5.2 Cost of goods sold

For the purposes of calculating a pricing structure, the cost of Oak should be amortised (or depreciated) over the life of the barrels with that charge used in the calculation of the cost of making wine. Depreciation on plant and equipment should be calculated using the equivalent cost of replacing wine productive capacity with new equipment. For example, if the current wine business capacity is 200 tonnes and the cost of building new wine production capacity is $1,500 per tonne, giving a cost of $300,000, and the estimated useful life of the equipment is 15 years, then the depreciation charge should be $20,000 per annum which equates to approximately $0.17 per litre produced.

A. Grapes

The **Ready Reckoner** uses a basic assumption that increasing grape quality will be required for increasing retail price points and there is a corresponding increase in the cost of grapes for higher retail prices.

In recent circumstances of oversupply of grapes, many varieties have been obtainable at prices as low as $200 per tonne. The **Ready Reckoner** ignores such anomalies and provides a sustainable cost of grapes for each retail price point

Wine businesses choose the desired wine region and variety and the **Ready Reckoner** will source the estimated average price from that region

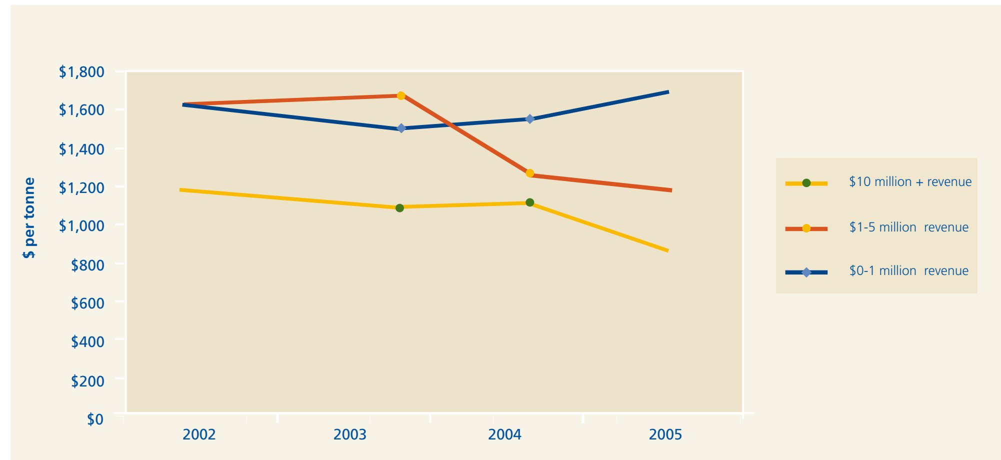
The **Ready Reckoner** firstly derives a grape cost per tonne based on the region and variety of grape selected (Source: AWBC/Winefacts). This cost is subsequently weighted, based on the retail price point of the wine. Discounted grape costs are included for wines retailing under $10 per bottle, average pricing is applied to $15-$20 wines and a premium is applied to $25 plus wines. Grape costs in the model range from $400 per tonne (basic) to $5,000 per tonne (luxury). These costs can also be manually adjusted.

Note that inputting an artificially low grape price due to oversupply will not be sustainable. For long term business analysis, realistic average (at least) grape prices should be used. It is expected that a similar '**Ready Reckoner**' for grape growing will be developed to more accurately analyse sustainable grape prices vis-à-vis costs of production.

Trends of external grape purchases

As shown in the table below, the cost of external grape purchases by wine businesses with less than $1 million of revenue has grown over the last three years, in contrast to wine businesses with $1 milllion-5 million of revenue and larger wine businesses with greater than $10 million of revenue.

Chart 8: External grape purchases: 2002 to 2005



These micro wine businesses ($0-$1million of revenue) tend to purchase select parcels of premium fruit intended for branded product where the margin is sufficient to justify the prices paid for the grapes.

B. Extraction rates

The extraction rate for grapes depends on many factors including grape variety and intended price point. The **Ready Reckoner** assumes the extraction rate will progressively decrease at higher price points, and ranges from 725 litres per tonne (basic) to 500 litres per tonne (luxury). The **Ready Reckoner** allows wine businesses to enter their own extraction rates to compare with **Wine Survey** benchmarks.

Allowances for evaporation, ullage and other losses have been considered via the inclusion of a wastage factor. While 9.1 litres of wine per case is often used to allow for wastage in larger wineries, the **Ready Reckoner** uses an assumed 3% wastage factor (or between 9.3 and 9.4 litres per case) but allows for the winery to manually input their own expected wastage factor.

C. Processing costs

Many small and medium wine companies do not correctly evaluate the true cost of producing wine.

Processing costs should capture all wine related costs including labour, overheads and depreciation. Exclusion of depreciation (due to a fully depreciated wine business) and other capital costs provides an artificially low assessment that, for example, does not adequately allow for machinery replacement costs.

Many wines are not released in the first 12 months of production, particularly for small wine businesses, and Cost of Goods Sold should also reflect interest (or finance costs) – included as a separate section below.

Processing costs in the **Ready Reckoner** for micro wine businesses ($0-$1 million) are set at $3 per litre and small wine businesses ($1-$5 million) at $2 per litre. These costs are based on the **Wine Survey** as well as observed industry standards and can be manually changed.

Some small wine businesses have their wine externally contract processed at rates in the range of $500-$600 per tonne even for higher priced wine. This appears to be significantly less than the costs which would be incurred by small wine businesses owning and operating their own equipment. When labour costs such as overseeing the wine made at an external facility, as well as freight and other charges are taken into consideration, it is possible the true costs are much closer to that of an in-house wine business.

D. Laboratory costs

Most small wine businesses will not have their own laboratory and will need to use an external laboratory for all wine testing. The best performing wine businesses factor such costs into any assessments of profitability, particularly for exported wine subject to independent testing by the AWBC.

E. Storage and handling costs

The significant costs associated with storing wine are often not separately identified by wine businesses.

The **Ready Reckoner** assumes a rate of 6.5 cents per month per litre for small wine businesses. Wine that requires special care and handling may cost between 2 to 3 times this amount. However, most higher priced wines requiring this level of care should generate sufficient margin to justify the additional costs.

F. Finance costs

Holding and maturing wine ties up working capital. While holding wine will generally aid maturation and thereby increase sales value, the interest cost must be recognised and has been separately included in the **Ready Reckoner**.

G. The cost of oak

The significant cost of oak barrels and associated depreciation is often not apportioned by wine businesses to the cost of goods sold.

The listed price for 300 litre Hogshead Barrels at the time of writing this guide was $800 for American Oak and $1,300 for French Oak. These levels have been used in the **Ready Reckoner** but users should be aware that Oak costs will vary based on quality and the buying power of the business. While a barrel may last five to seven years, the majority of use for oak flavour occurs in the first three years.

Oak costs have been separated in the Ready Reckoner, based upon the expected number of months in barrel, to enable a more accurate portrayal of total costs. The separate holding costs also account for time in tanks or bottle before sale.

The financial effects of oak fermentation have been explained through a separate case study ‘Costs of Wine Maturation’.

Import duty rebates

Wine businesses should also be aware that import duty rebates may be available for barrels imported from overseas suppliers under the Tradex scheme. Tradex provides for duty and GST free importation of goods that will be exported, either unaltered or incorporated into other products. While accessing Tradex does not cost anything, the importer is required to export the goods within 12 months or another agreed timeframe. If for any reason the goods are not exported within the agreed timeframe (usually four years in regard to barrels), the duty, which would have been paid if not for Tradex, becomes due and payable to AusIndustry within 28 days. Further information is available at http://www.ausindustry.gov.au

H. Packaging costs per case

The costs of bottling, labelling, cartons and other packaging supplies have been calculated in the **Ready Reckoner** according to the intended price point.

The **Ready Reckoner** uses a range of $10 per case (basic) to $24 per case (luxury) for packaging. These estimates are based on the best performing wine businesses in the **Wine Survey** and are considered to be target packaging costs for each price point. Individual wine business costs will vary from these estimates and these costs can therefore also be manually entered.

I. The value of grapes from owned vineyards

Many small wine businesses account for the cost of grapes from their own vineyards at the cost of production. The alternative to using the costs of growing grapes for determining pricing and cost of inventory is to price grapes at district weighted averages or an estimated market price for the grapes. This is the method prescribed in the Australian Accounting Standards (Australian Equivalents to International Financial Reporting Standards, A-IFRS) and is mandatory for all wine businesses that are required to produce General Purpose Financial Statements. Individual wine businesses should consult their accounting advisors.

The large wine business benchmarking guide discusses in greater detail accounting for the value of grapes for owned vineyards in accordance with Australian Accounting Standards.

5.3 Inventory

The following table shows the inventory and working capital ratios for the best performing small wine businesses.

Table 5: Inventory and working capital ratios – best performers (2005 **Wine Survey**)

Inventory and working capital	$0-1m Best	$1-5m Best
Inventory to COGS	1.48	1.85
Inventory turnover	0.66	0.74
Working capital to sales	1.22	1.13
Working capital to COGS	2.40	2.02
Non-current inventory %	42%	43%

Inventory ratios

The average proportion of non-current inventory held is just over 40% of total inventory and the 'Inventory to COGS ratio' suggests that the average small wine business is holding between one and a half and two years of sales as inventory.

Working capital ratios

In terms of working capital ratios, on average, in 2005, Australia's small wine businesses were tying up 1.13 to 1.22 times the value of wine sales as working capital.

This means that for every $1 increase in sales, $1.13 to $1.22 of working capital will be required. This can have a significant impact on cash flows when a business is growing.

An increase in working capital is a requirement to achieve sales growth for any business. Additional working capital must be provided either through cash reserves or an increase in borrowings or equity. To grow a wine business with sales turnover of $2 million by 25% ($500,000) will require an increase in working capital of $565,000–$610,000 in average terms.

The precise amount and time of the funding of the working capital will depend on the selling pattern of the wine. A critical aspect to consider in seeking an increase in overall sales revenue is cash flow implications on the business during the process to build sales.

Critical decisions for a small company include:

- if targeting an increase in the average sale price of wine through extending the holding period and producing a higher quality product, is the incremental lift in the selling price greater than the costs of holding the wine?
- does the business have the financial capacity to fund the working capital required to hold wine for longer or increase sales volumes?

This example clearly demonstrates the need for a wine business that is planning substantial sales growth to consult their financial or accounting advisor to develop a detailed cash flow model that accurately depicts the working capital needs corresponding to the targeted increase in sales. These cashflows then need to be discussed with the wine business' financiers or bankers to determine the best approach to financing the targeted growth.

Weighting of red to white

The average inventory mix for micro wine businesses is represented by up to 90% as red wine, the majority of which is maturing in barrels. Small wine businesses have on average over 75% inventory as red wine.

While many small wine businesses produce high value, matured, red wines, it should be noted that the associated production and maturation process incurs significant costs and cash flows from sales are often not received until several years after the costs have been incurred.

Many successful small wine businesses have a balanced mix of white wines or a rose which requires less maturation and deliver cash flows soon after production in addition to higher value red wines.

Managing vintage variation

Managing output and production as a result of variation in quantity and quality from vintage to vintage is a challenge for all wine businesses but is a particular challenge for small wine companies.

For example, a small wine company that has approximately 5,000 case sales across all of its brands could vary in production up to 8,000 cases in a high volume year and down to nil in a very poor year.

The small wine company has a challenge to then determine its sustainable sales for each brand and to ensure that they do not overproduce for a particular brand or label and risk it being discounted in the marketplace.

If a small wine business has an 'iconic' wine with sustainable annual sales of 1,000 cases and a retail price of $50 per bottle, production of 2,000 or 3,000 cases of that wine could lead to discounting and devaluing the brand with longer term demand and margin implications.

One strategy to manage this challenge could be the use of disposable brands which are introduced in those years where excess production occurs. The small wine company would require a clear pricing and marketing strategy for the additional production by understanding their full costs of production and the impact of fixed and variable costs in years of over-production.

The converse example is in a year where there is an extreme shortage of quality fruit. Some small wine companies make the decision to not produce certain brands in a particularly poor year, or produce only very limited quantities to ensure quality is maintained. Small wine businesses should strive to keep loyal customers informed of low (or nil) production to maintain brand loyalty and offer alternative products if possible.

Excess stock

Most small wine businesses manage their inventories well and are not exposed to large stock write-downs. However, it is very important to not over produce wine or over-order packaging items based upon unrealistic sales projections.

One of the most critical elements of managing a wine business is the constant need to match demand for your wine to the supply of grapes and wine. Any inventory which cannot be sold as branded product is often sold as bulk wine or unbranded – potentially at a significant loss.

Example: a good vintage

When a particular vintage produces a better than expected wine, it is tempting to produce more of the high quality, higher priced products than planned.

However, as there are limited markets for these wines, this can lead to supplying the trade with too much product. This can in turn result in discounting which sends a message to consumers that they have been overcharged for the wine in the past and makes it difficult to sell the wine at full retail value in the future.

As the price of wine is generally associated by consumers with quality, discounting may also decrease the consumer's perception of the wine's quality.

One possible use for excess high quality wine may be to blend it with less expensive wine which may improve the saleability of the lower priced product.

Wine businesses will need to develop their own strategies to sell any excess stock without negatively impacting their brands.

6. General and administration expenses

This category should include all overhead costs of operating the wine business which are not directly related to the production of wine.

Examples would include office costs, computer hardware and software expenses, postage and printing, salaries (excluding cellar, winemaking and sales and marketing salaries) and other general expenses.

Based on the Wine Survey and industry experience, many small wine businesses do not use full absorption costing and include items as general and administrative costs that should have been applied to cost of goods.

Full absorption costing should be adopted to more clearly reflect the true costs of wine production and provide more accurate information on which to base sales decisions.

General and administrative expenses in the Ready Reckoner assumes a sustainable level of 15% of revenue for small wine businesses.

The best performing wine businesses incurred general and administrative expenses of 12-13% of turnover, which indicates that a target of 15% is achievable.

Careful cost management in this area can significantly improve profitability. Below are some examples of cost improvement strategies adopted by the best performing small wine businesses.

6.1 Use of external consultants/accountants/lawyers versus in-house expenses

Finance, accounting, legal and other professional costs can be a significant impost for small wine businesses that often rely on external providers for these services.

Small wine businesses should assess skills available within the business bearing in mind realistic time constraints on staff (including family business members). Consideration should be given as to whether it is feasible to provide appropriate training for a staff member to carry out certain roles such as in computer accounting packages, or whether it is more practical to out-source.

Example 1: grouping of requirements for a service provider

For small wine businesses that outsource professional services such as preparation or review of financial statements, tax returns, legal documents, etc, it may be less to combine the requirements with similar businesses in their region and approach an external service provider on a group basis.

By combining the needs of local operators and approaching an accounting or legal practice with a portfolio of wine businesses, the costs for each are likely to be cheaper.

Alternatively, it may be appropriate to employ an accountant or lawyer for the region or for a group of businesses in a region.

It is important to first consider the advantage of internally sourcing such resources, even if on a part-time basis.

Example 2: pooling of interests to obtain purchasing power and/or economies of scale

This same approach can be used by small winemakers to group together to purchase supplies (such as glass) or other business inputs. Several successful buying pools have already been established in Australia. Similarly, wine businesses may consider joint ventures with a nearby winery or vineyard to share the cost and use of winery or vineyard equipment and even contemplate a contract service to others in the district.

6.2 Foreign exchange

Most small wine businesses invoice in AUD and are not exposed to foreign currency fluctuations. However, if an importer will only accept payment in their own currency, depending on the size of the sale, the wine business should consider taking out a hedge on the sale transaction to fix the sale proceeds.

Example: foreign exchange hedge

An Australian exporter selling AUD 100,000 of wine to a US customer, on a day when the exchange rate is 0.75, will, on delivery of the wine, be paid USD 75,000.

If, during the interval between sale and delivery, the exchange rate alters so that USD 75,000 is now worth only AUD 95,000, the wine business has lost AUD 5,000.

The exposure to such a potential loss may be eliminated or minimised when the sale is negotiated by contracting with a bank to sell USD 75,000 and receive AUD 100,000 at the expected time of delivery of the wine.

When delivery is completed the wine business receives USD 75,000 and pays the USD 75,000 to the bank in exchange for AUD 100,000 thus fixing the sale proceeds.

The cost of taking out such insurance will be a relatively small fee charged by the bank in order for it to carry the foreign currency risk.

Exporters should also consider taking out export insurance to cover the risk associated with the buyer paying for the goods on delivery.

7. Balance sheet structure

The way in which a wine business structures its operations will affect its profitability and cash flows. The table below provides a guide as to one structure of the Balance Sheet that can be considered when analysing business performance. The basis of preparation of these balance sheets is set out in the assumptions following the table. When comparing this 'working model' balance sheet, it is important to be aware of differences in business operations and structures that would explain variations from the model such as the amount of purchased fruit versus own estate fruit, contract processing, age of equipment and vineyards and key impacting items such as inventory turnover and the fluctuations this has on balance sheet results through the course of the year.

Table 6: Model balance sheet

2005	Case Sales Revenue $1 million		Case Sales Revenue $5 million	
Assets				
Current assets	**$'000**	**%**	**$'000**	**%**
Cash	0	0.0	0	0.0
Receivables	170	17.0	800	16.0
Inventories	1,125	112.5	5,060	101.2
Other current assets	0	0.0	0	0.0
Total current assets	1,295	129.5	5,860	117.2
Non current assets				
Land	110	11.0	400	8.0
Vineyards	330	33.0	1,250	25.0
Buildings and improvements	50	5.0	100	2.0
Plant and equipment	200	20.0	1,395	27.9
Total net fixed assets	690	69.0	3,145	62.9
Total assets	1,985	198.5	9,005	180.1
Liabilities and equity				
Current liabilities				
Notes payable and bank debt	150	15.0	1,000	20.0
Provisions	0	0.0	25	0.5
Trade payables and accruals	170	17.0	800	16.0
Total current liabilities	320	32.0	1,825	36.5
Non current liabilities				
Long term debt	900	90.0	3,860	77.2
Non-current Provisions	0	0.0	50	1.0
Total non current liabilities	900	90.0	3,910	78.2
Total liabilities	1,220	122.0	5,735	114.7
Equity	**765**	**76.5**	**3,270**	**65.4**
Total liabilities and equity	**1,985**	**198.5**	**9,005**	**180.1**

Note: % – represents figures indicated as a % of case sales revenue

Assumptions

The following assumptions have been used in building the model balance sheet:

i. portfolio mix – cases of wine sold in each price segment are approximated as per the figures in charts 1 and 2;

ii. sales channels are approximated as the percentages listed in charts 5 and 6

iii. debtor days – 60;

iv. creditors assumed to be the basis for funding debtors thus cancelling the two figures;

v. % of grapes from own estate – 100% for $1 million and 55% for $5 million;

vi. inventory turnover – 25 months for $1 million and 27 months for $5 million;

vii. debt levels are based on funding of assets such that 50% of inventory is funded by debt, 60% of vineyards is funded by debt and 90% of plant & equipment is funded by debt;

viii. vineyards are valued at $55,000 per hectare of developed vineyard, including land;

ix. buildings, plant & equipment are assumed at a cost of $2,000 per tonne capacity for $1 million and $1,750 per tonne capacity for $5 million;

x. operations are assumed to be at approximately full capacity;

xi. there is no contract processing; and

xii. there are minimal bulk wine sales.

Key aspects

The key aspects to consider when analysing the above Balance Sheet, and indeed individual enterprise Balance Sheets, are:

Debt/Equity

The model shows for both wine business sizes a debt/equity ratio of approximately 1.4-1.5:1. This ratio provides a reasonable balance between return on equity being a relatively conservative 8-12% and the ability to withstand the pressure caused by vintage fluctuations on lending covenants imposed by banks. It should be noted that the level of equity in the balance sheets of small wine businesses, particularly micro businesses, is often understated. This is because the recorded equity does not represent the value of other assets of the proprietors that have been provided as security for the business.

Inventory

Not surprisingly, the most significant element of current assets is inventory as small wine businesses tend to hold high levels of inventory for maturation purposes.

While the **Wine Survey** requested participants to record all inventory as current for comparative purposes, in reality, a large proportion of inventory will not be sold in the first 12 months after manufacture. The proportion of non-current inventory is analysed in the 'Cost of Goods Sold and Inventory' section of this report.

The model also demonstrates the investment impact of carrying inventory for greater than 24 months and the need for the wine businesses to be able to achieve a minimum gross margin of 50% on sales. The holding costs associated with this inventory structure are approximately 20-25% of the sale price of the wine.

Fixed Assets

Wine businesses are very asset intensive businesses. The model wine business structure has inventory representing some 120% of sales for $1 million and 105% of sales $5 million. 'Fixed Assets' represent approximately 80% of sales for the $1 million and 65% of sales for the $5 million model wine business structure. Total Assets represent approximately 220% of sales and 185% of sales respectively. By comparison, the definition of a large proprietary company in the corporations law uses a ratio of total assets to sales of 50%. Wine businesses should be aware of the nature of wine businesses when analysing their own balance sheet structure.

Growth

The model clearly demonstrates the growth challenge for any wine business. To be able to support sustainable growth a wine business must be able to access debt or equity funding of approximately double the forecasted sales growth.

Following are some examples of key areas of the way in which the best performing small wine businesses structure their business and minimise costs.

7.1 Wine business structure: asset ownership

Wine businesses with case sales of less than $1 million are made up of an ever expanding variety of business structures. The traditional vertical business could be comprised of 5-15 hectares of vineyards and a production facility of up to 100 tonnes. The opposite end of the scale is the virtual business where the proprietor(s) own no assets and contract the entire process from grapes through to production and distribution to third parties and only actually own the brands. Variations between these two extremes are based on different components of vineyard and other asset ownership, contract processing and distribution models.

Wine businesses expand from micro (less than $1 million) to small (between $1 million and $5 million) using a variety of growth strategies. Based on the **Wine Survey** and industry experience, the best performing micro and small businesses generally own their own vineyards and production facilities but have used third party grape growers and contract processing as catalysts for growth.

The challenge for many small wine businesses is to access the capital required to start-up and then grow the business. Capital is split between two distinct categories, debt and equity. The sources of each of these options is:

Debt	Equity
Banks	Proprietor(s)
Finance companies	Family and friends
Suppliers	Retained profits
Distributors	Suppliers
Other third parties	Distributors
	Third party investors – Individuals – Corporates – Equity funds

There are other sources of debt and equity that relate to the financial markets, but these are generally only available to much larger businesses due to the costs of procuring this form of capital.

There has also been an observed increase in sale and leaseback transactions for small wine businesses, particularly in relation to vineyards. This involves operators selling and then leasing back assets thereby maintaining a strong level of quality control by having employees in place at the vineyard. The benefit for the operator is to free up capital for business development and expansion.

In relation to sale and leaseback of a vineyard, while ownership and the capital risk and benefits (being the potential increase or decrease in value of the vineyard) transfers to the lessor, the lessee enters into a long-term contract to receive the grapes. The lessee can also be involved in the management of the vineyard to maintain quality of grapes.

7.2 Use of partnerships and joint ventures

Another opportunity is to enter a form of partnership or joint venture.

Such an arrangement may facilitate the expansion of a wine business or improve the under-utilisation of a winery. An investor may be prepared to fund assets whereby the vineyard owner and wine business operator could be different people.

Such ventures allow the small wine business to share both the risk and the rewards of the venture and minimise its own capital outlay.

7.3 Creating the appropriate wine business structure

The appropriate structuring of the business will assist in achieving the sustainable margin and profit levels discussed earlier in the report.

Financiers will often be reluctant to lend significant funds to a new wine entity with no sales history that has yet to prove it can operate a successful business.

Often it is necessary for the owners to guarantee the debt and secure it against personal assets.

Banks will typically lend up to 50% of the value of the secured assets to small wine businesses with the remainder financed by equity investment. Friends or family may provide such a guarantee or directly invest funds (equity).

Many small wine businesses tend to consider equity investment when the business and/or the industry is in a down cycle or they are facing financial difficulty. This is generally the worst time to seek equity as the indicative valuation placed on the business by the equity investor will tend be low resulting in them securing a higher proportion of equity for their money than might otherwise be the case. A better time to seek equity is when the business is enjoying a successful period in preparation for potentially difficult times or future expansion.

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