

# WINE AUSTRALIA: DIRECTIONS TO 2025



## BENCHMARKING GUIDE LARGE WINE BUSINESS



Australian Government  
Australian Wine and  
Brandy Corporation

wfa Winemakers'  
Federation  
of Australia  
*For the Industry by the Industry*

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# 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).

The objective of this guide is to present information that wineries can analyse to identify potential areas where they could improve their businesses. 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 large wineries. These judgements are the view of the authors with an overview from wine industry practitioners. The ‘Best Performing’ wineries are the top 25% for the large winery category.

Unless otherwise stated, for the purposes of this guide a large wine business is defined to have the following characteristics:

- gross case sales revenue exceeding \$20 million;
- sales exceeding 200,000 cases; and
- winery processing capacity in excess of 7,000 tonnes.

The nature and structure of larger wine businesses can vary in many respects including, but not limited to:

- single production site versus multiple production sites;
- single region or state versus multiple region or state;
- level of contract crushing;
- mix between branded production and bulk wine production;
- level of bulk wine purchased for branded product;
- mix between own vineyards, purchased grapes and mix of contract and spot purchases;
- size of the winery production facility varies significantly from a minimum of 7,000 tonnes to in excess of 120,000 tonnes; and
- public versus private ownership.

The many potential variables listed above mean that each wine business will be different depending on structure and operation. For the purposes of analysis, this guide has been structured based on the following characteristics for a large wine business:

- single production site;
- production capacity of 7,000 to 50,000 tonnes;
- revenue in the \$30 million-\$100 million range;
- no contract processing – either by the business for others or by others for the business;
- predominantly a branded product business;
- not a listed public company;
- the winery is not part of a foreign owned company; and
- the wine business is stand alone and does not form part of another business such as a multi-beverage operation.

The guide has also been structured to focus on the areas of operation that a large wine business might face different challenges to that of a medium or small wine business. Many areas covered in the medium or small wine business guide that may be equally applicable to a large wine business are not covered in detail in this guide, such as cellar door and wine tourism operations, sales to local restaurants, and working capital issues.

This guide covers the following areas for large wine businesses:

- sustainable gross margin;
- portfolio mix and product development;
- sales channels – the supermarket challenge;
- grape supply strategy and managing vintage variation mix; and
- variables involved in moving from a large to ‘major’ winery.

This guide does not analyse ‘Major Wine Businesses’ as they are virtually individual case studies in themselves and display different operating and structural characteristics.

There is no specific definition of the size that describes a major wine business. The general characteristics of a business that might be considered a ‘major’ wine business in Australia include:

- multiple production facilities and a significant quantity of fruit sourced from the large irrigated regions of the Murrumbidgee Irrigation Area (MIA), Sunraysia and/or the Riverland;
- at least one production facility in excess of 75,000 tonnes;
- sales turnover in excess of AUD 200 million; and
- generally a large and diverse brand portfolio. This is difficult to define but could be in excess of 50 brands with total sales of more than 500,000 cases or bulk wine sales in excess of 100 million litres.

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

## Sustainable large wine business

The best performing wineries over \$20 million of case sales revenue are returning Earnings Before Tax (EBT) of 15%.

Sustainable large wine business must maintain a gross margin in the range of 45-50% to ensure profitability and cashflow to:

- invest in continual upgrades of operating infrastructure, including appropriate vineyard and production capacity;
- invest in continual brand development and brand enhancement;
- be able to navigate the impact of vintage variation; and
- have the capacity to meet the pricing needs of the supermarket chains in relation to the high volume, lower margin part of the business.

The 45-50% range for sustainable gross margin level is the **minimum** to achieve an Earnings Before Tax (EBT) range of at least 10% and targeting 15% based upon anticipated:

- sales and marketing expenses of 17% of case sales revenue
- general and administration expenses of 12% of case sales revenue; and
- interest of 6% of case sales revenue, based on a debt to total assets ratio of 65%.

## Product portfolio mix and product development

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

- identification and targeting appropriate price points;
- selecting the appropriate sales channels for their brands;
- maximising the return on dollars spent on sales and marketing support; and
- balancing spend on sales and marketing support and product development and enhancement.

## Sales channels – the export opportunity and the supermarket challenge

### The Export Opportunity

#### Relativity of export price points

The export markets in most major Western economies have price point sectors that are not inconsistent with the Australian domestic market. Table 4, in Section 4, is an indicator of the comparable price points in the Australian, US and UK markets.

The large wine businesses maintain a broad portfolio that includes higher price point brands.

The best performing large wineries have a presence in most international markets where Australian wine is sold, with a concentration in the UK and US markets as well as a strong domestic position.

### Retail – The Supermarket challenge

The retail alcoholic beverage (liquor) market has followed the national retail trend with somewhere in the vicinity of 50% of retail sales controlled by Woolworths and Coles.

Supermarket chains, both in the domestic and export markets, provide the opportunity for exposure to a large number of potential consumers. This exposure comes at a cost and wine businesses need to be able manage the challenging price and volume equation which generally means very tight margins.

One of the key considerations in accessing this channel is the impact of discounting and selling on promotion.

#### The effects of discounting

Wine businesses that trade with the large retail chains in Australia and internationally provide a range of discounts or rebates.

In the UK retail market for example, it is estimated that from 60% to 80% of lower price high volume wine is sold on promotion.

#### Management of discounts and rebates

It is imperative that large wineries actively manage their discounts and rebates with retailers on a timely basis and clear as many rebates, discounts or short payments as soon as practically possible.

#### Financial impact of selling on promotion

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.

#### Cost implications

Wine businesses must have a detailed understanding of cost structures at every level when considering major retail outlets. Selling significant volumes through the supermarket channel is heavily impacted by competition from major wine businesses that have large-scale production facilities in excess of 75,000 tonnes capacity.

## Managing vintage: grapes, inventory and costs

The grape supply strategy and managing vintage variation mix are important factors for any large wine business.

The transition from a medium to a large wine business provides a supply challenge. The agricultural nature of the supply side of the wine sector delivers raw material variation that can be as significant as 70% in extreme circumstances but is more likely to be in the vicinity of 20 to 30% in any given year. This creates a supply challenge both in relation to quantity and quality of grapes.

### Costs of production

#### 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.

With many grape varieties in over-supply in recent years, grapes 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 based on average prices.

#### Processing costs

Processing costs in the **Ready Reckoner** have been set at \$0.50 per litre for large wineries (Revenue \$20 million to \$100 million and a production facility of 7,000 to 50,000 tonnes). The **Ready Reckoner** defines major wine businesses (production facilities of greater than 50,000 tonnes) to have a production cost at \$0.25 per litre or around \$190 per tonne. These costs are based on the **Wine Survey** as well as observed industry standards and can be manually changed. They are also indicative of full capacity processing and would be higher in years of short grape supply in particular.

Many wines are not sold in the year of manufacture and the Cost of Goods Sold should reflect interest (or finance costs).

#### Finance costs

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

#### The cost of oak

Oak maturation is a relatively small cost for higher volume lower priced wine as it does not normally undergo barrel fermentation.

#### 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 costs.

#### The Value of Grapes from Owned Vineyards

Most large wineries who own vineyards have been applying the Self Generating and Regenerating Assets (SGARA) Accounting Standard for several years. The Standard applied from financial years ending on or after 30 June 2001 for all reporting entities and required grapes and vines to be measured at market value.

## Inventory

A critical challenge for medium and large wine businesses is the management of inventory levels and the constant need to match demand for wine to the supply of grapes and wine.

Inventory levels must be managed against a strategic supply plan which includes:

- vintage plan;
- managing supply surplus and deficit;
- blending; and
- creation and management of disposable brands.

## General & administrative 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 audit and tax fees, consultancy, office costs, computer software expenses, postage and printing, salaries (excluding cellar, winemaking and sales and marketing salaries) and other general expenses.

## Balance sheet structure

The way in which a wine business structures its business will affect its profitability and cash flows. The table provided in Section 7 provides one model of the Balance Sheet structure of a large wine business. 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. This could include 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 fluctuations through the course of the year.

## 2. Sustainable large wine business

The table below indicates the current financial performance of the best performing large wineries and a suggested 'sustainable performance level'.

The results are adjusted to exclude contract processing and the best performers are the top 25% of wineries in this category.

Table 1: Sustainable Large Winery

Annual revenue	\$20m+ Average	\$20m+ Best Performers	Sustainable
Sales	100%	100%	100%
Cost of goods sold	62%	54%	55%
Gross margin	38%	46%	45%
Sales and marketing expenses	16%	17%	17%
General and administration expenses	13%	13%	12%
Earnings before interest & tax	9%	16%	16%
Interest	3%	1%	6%
Earnings before tax	6%	15%	10%

Notes:

1. The sales revenue is adjusted to include foreign exchange gains/losses and exclude contract processing businesses. Foreign exchange gains/losses were included in revenue consistent with accounting standards requirements. Contract processing is assumed to be on overhead recovery basis and the adjustment is an equal reduction of revenue and COGS
2. Figures presented as percentages relative to total case sales revenue
3. Interest is low for average and best performers representing mature businesses with low borrowings; in contrast, the sustainable model assumes a level of borrowings that equates to 65% of total assets.
4. Modified to aggregate other non-operating income /expenses with Administration expenses.

The best performing wineries over \$20 million of case sales revenue are returning Earnings Before Tax (EBT) of 15%.

Sustainable large wine businesses must maintain a gross margin in the range of 45-50% to ensure profitability and cashflow to:

- invest in continual upgrades of operating infrastructure, including appropriate vineyard and production capacity;
- invest in continual brand development and brand enhancement;
- be able to navigate the impact of vintage variation; and
- have the capacity to meet the pricing needs of the supermarket chains in relation to the high volume, lower margin part of the business.

The 45% sustainable gross margin level is the **minimum** required to provide earnings before tax (EBT) of 10% (and targeting 15%) based upon the following assumptions:

- **sales and marketing expenses** of 17% of case sales revenue;
- **general and administration expenses** of 12% of case sales revenue; and
- **interest** of 6% of case sales revenue, based on a debt to total assets ratio of 65%.

The minimum gross margin of 45% is somewhat higher than that reported by average large wineries from the **Wine Survey** as shown in the following table:

Table 2: Gross Margin (Wine survey)

Winery sales	Average gross margin	Average gross margin	Average gross margin	Best Performers gross margin
	2003	2004	2005	2005
> \$20 million	43%	35%	36%	42%
Adjusted for contract processing & foreign exchange gains/losses	46%	37%	38%	46%

The **Ready Reckoner** model assumes a sustainable gross margin of 45% for large wineries and highlights scenarios that generate gross margins below this level. Lower average gross margins in 2004 and 2005 reflect eroding margins for Australian wine businesses in recent years.

# 3. Product portfolio mix and product development

The best performing large wine businesses generally focus on the following items in terms of sales and distribution with varying emphasis on different aspects depending on the individual nature of the business:

- identification and targeting appropriate 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.

## 3.1 Price points

### What proportion of wine is sold in each price segment?

The following charts demonstrate that large wineries operate across all price points. While the best performing large wineries did not operate in the less than \$7 per bottle segment, they had a higher proportion of cask sales.

Chart 1: Revenue by price point (\$20 million plus – average)

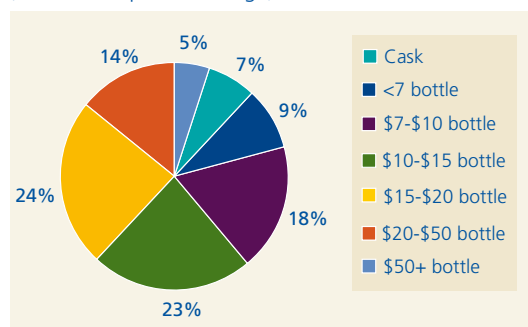
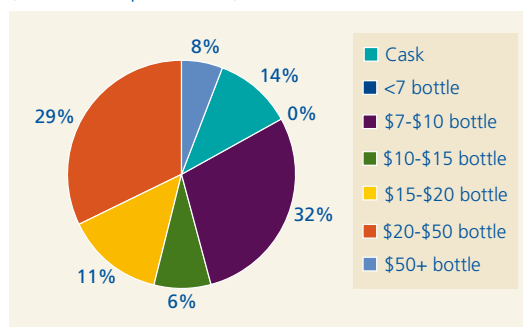


Chart 2: Revenue by price point (\$20 million plus – best)



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

Chart 3: World Wine Sales (Rabobank)

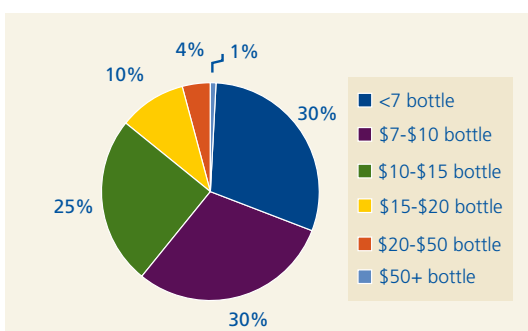
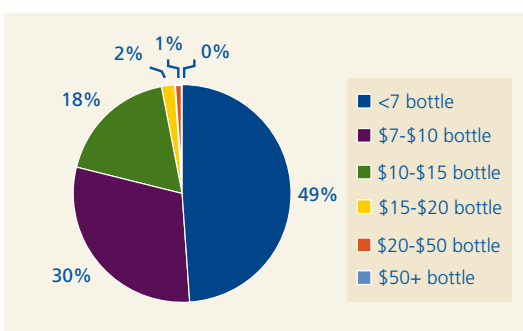


Chart 4: Advertised retail wine prices (LMA Database)



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

More than 85% of wine sold around the world (refer Chart 3 above) and 97% of the wine advertised in the retail sector in Australia (refer Chart 4) is below \$15 per bottle.

Many of the best performing large wineries target the majority of their wine portfolios by volume in these price segments complemented with smaller volumes of higher priced well recognised leading brands.

The relationship of wine portfolio structure to gross margin is direct and the impact is summarised in the following table:

Table 3 – Portfolio structure

		Top quartile	Survey average	Low price producer
	Price \$/750ml	Cases 12x750ml ,000	Cases 12x750ml ,000	Cases 12x750ml ,000
Luxury	75R/50W	10	5	2
Ultra Premium	35R/25W	65	30	8
Super Premium	18	45	110	40
Premium	12	40	150	100
Popular	8	305	185	200
Basic	5	0	130	500
<b>Total</b>		<b>465</b>	<b>610</b>	<b>850</b>
		<b>Litres ,000</b>	<b>Litres ,000</b>	<b>Litres ,000</b>
Cask	\$2/litre	4,750	250	350
Bulk	\$0.60/litre	320	1,100	2,150
<b>Profit &amp; loss summary</b>		<b>\$m</b>	<b>\$m</b>	<b>\$m</b>
Revenue		36.0	36.0	36.0
Cost of goods sold		18.3	20.9	24.1
<b>Gross margin</b>		<b>17.7</b>	<b>15.1</b>	<b>11.9</b>
GM %		49%	42%	33%
\$/case		77	59	41

**This table provides a very definite indication on the benefits of a large wine business investing in the development of strong brands across price points. Higher price points are necessary to balance the lower price point, higher volume brands to ensure sustainable returns to the wine business.**

The following comments could be made with respect to the table above and wine business operations:

- wine quality must be matched to price point in order to drive sustainable brands. Today's consumers are more aware of wine quality and will not accept sub-standard products in higher price points. The ability to sell wine in the \$15 to \$50 range and above (super premium, ultra premium and luxury) requires a product that consistently performs to consumer expectations and has some level of differentiation from wines in the \$10 to \$15 Range (Premium);
- wine businesses must have a strategy to manage poorer quality vintages to ensure consistency in quality to maintain brand loyalty. This guide will discuss supply challenges; a sustainable wine brand must be produced in such quantities that maintain the quality expectations even during poorer quality vintages;
- the best performers have reasonably significant volumes in the ultra premium range (\$25 to \$50). Whilst it is difficult to generalise, a strong ultra premium brand could sell between 2,000 and 10,000 cases. In terms of the portfolio analysis in Table 3, the best performers would be looking at some 10 to 20 labels in the ultra premium range which would generally incorporate a mix of variety and region;
- the best performers have developed a strong brand in the \$7-10 range. This price point can achieve acceptable returns, providing the efficiency of the production facilities and the grape costs are appropriate;
- the best performers have limited or no exposure to the \$5 per bottle and under range or the export equivalent. This range is the province of 'major' wine businesses which have the production and distribution economies of scale to compete profitably in both the domestic and export markets. They are often global businesses and have production facilities in excess of 75,000 tonnes capacity and have been excluded from this analysis;
- the best performers have developed a small but sustainable cask business that allows them to sell the majority of their excess bulk wine at a reasonable margin. The margin achieved by developing a sustainable cask business, particularly if it is in the 'premium' cask range (2 litre casks), is significantly better than the sub \$5 per bottle range. This is primarily due to the packaging cost differential of between \$0.50 and \$1.00 per litre equivalent which equates to between 25% and 50% of the ex-winery sales value of the wine;
- the best performing large wine businesses use bulk wine purchases to maintain brand volumes for cask when necessary; and
- they do not generally rely on sales into the bulk wine market as a major sales channel but rather use it as a means to dispose of excess production in large vintages.

### **Matching styles to market**

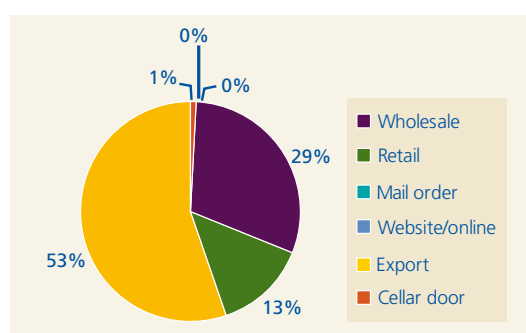
The best performing large wineries have developed successful brands through understanding the wine style preferences of each market and producing wine to suit varying preferences. For example, some international markets prefer sweeter wines than those traditionally made in Australia and the export wines might be different to domestic Australian wines to accommodate this difference.

# 4. Sales channels – the export opportunity and the supermarket challenge

## 4.1 Sales channels

The following chart illustrates the proportion of wine sold through each sales channel by Australia's large wine businesses.

Chart 5: Sales channels (\$20 million plus)



Each sales channel should be treated as a profit centre. The quantity of wine sold, and the price and margin the winery achieves for the same product, is likely to differ for each sales channel.

For the purposes of this guide, we have concentrated on two key sales channels for the large wine businesses:

- overseas – the export opportunity;
- retail – the supermarket challenge.

### A. The export opportunity

The Medium Wine Business Guide provides a detailed analysis of the export market. This guide will focus on two key points considered to be more relevant for the larger wine businesses.

- relativity of export price points;
- distribution considerations.

#### Relativity of export price points

The export opportunities for large Australian wine businesses should be analysed in conjunction with lessons learned from the domestic market.

The export markets in most major Western economies have price point sectors that are not inconsistent with the Australian domestic market. The following table is an indicator of the comparable price points in the Australian, US and UK markets. This terminology has been adopted for the purposes of the Small, Medium and Large Wine Business Guides, although it is difficult to get consistency across publications and industry commentary.

Table 4: Retail price points

	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 ~4litre	10-12	n/a	6-9

This table highlights that each market has its own price/value equation influenced by local considerations. The comparable price points are not a straight relationship between exchange rates. This is a critical consideration for all Australian wine businesses looking at export opportunities.

The large wine businesses maintain a portfolio that includes higher price point brands in both the export and domestic markets.

The best performing large wineries have a presence in most international markets where Australian wine is sold, with a concentration in the UK and US markets as well as a strong domestic position. More recently, these wineries have enjoyed success in the Canadian market and are starting to see traction in some Asian markets (including China, Japan and India).

Any international transaction attracts an element of risk in the form of foreign currency movements if the sales are made in a currency other than Australian Dollars. Some large wineries choose to hedge their foreign exchange risk as explained in detail in the Medium Wine Business Guide.

The **Ready Reckoner** model takes into account all relevant import, distribution and retail margin considerations for each market. It also provides for the different levels of duties and taxes imposed in those locations.

## B. Retail – The supermarket challenge

The Australian retail sector has changed dramatically in recent times. There has been a consolidation in the food and grocery sector that has left three major components in the Australian market:

- Woolworths;
- Coles; and
- independents such as Foodland and IGA.

The retail alcoholic beverage (liquor) market has followed this trend with somewhere in the vicinity of 50 % of retail sales controlled by Woolworths and Coles.

The important factors to consider when analysing the impact of consolidation of the retail liquor market are:

- consumers will generally have a limited monthly budget and the major supermarket chains create an opportunity to purchase wine across the price, variety and regional spectrum;
- wine businesses can move significant quantities of wine through this distribution path; and
- major retail chains have extensive advertising markets and a percentage of this is dedicated to alcohol.

The costs to access this sales opportunity can be significant:

- retail chains are publicly listed companies and will constantly looking for the balance between price, volume and margin;
- shelf space in the retail chains comes at a cost, which includes rebates, cooperative advertising and other promotional commitments;
- trading conditions generally mean the retail outlet offers the tightest margin for wine businesses compared with other sales opportunities;
- 'buyers own' brands and cleanskins have the capacity to take shelf space away from other wine brands; and
- once a winery is geared to producing significant volumes for the supermarket trade, there is an ongoing dependence to move these significant volumes of product.

Supermarket chains, both in the domestic and export markets, provide the opportunity for exposure to a large number of potential consumers. This exposure comes at a cost and wine businesses need to be able manage the challenging price and volume equation which generally means very tight margins.

One of the key considerations in accessing this channel is the impact of discounting and selling on promotion.

### **The effects of discounting**

Wine businesses that trade with the large retail chains in Australia and internationally provide a range of discounts or rebates.

In the UK retail market for example, it is estimated that from 60% to 80% of lower price high volume wine is sold on promotion.

The types of promotions offered take many forms, including 'Buy One Get One Free' (BOGOF) and three for two (Threshers, UK) offers. In addition, wine businesses may be asked for contributions to promotions budgets such as Advertising, Marketing, Promotion (AMP) – per case or Advertising, Marketing, Promotion (AMP) – dollar amount.

### **Management of discounts and rebates**

Due to the often large volume and variety of promotional programmes undertaken by a winery and a retailer each year, the management of the discounts and rebates can be difficult and time consuming.

Retailers sometimes have poor records and documentation of rebates or discounts, particularly as they are offering a vast range of programmes to a significant number of Australian and other international wineries.

It is common for the retailer to deduct the rebate off the payment for the wine but provide no documentation.

It is therefore imperative that wine businesses actively manage their discounts and rebates with retailers on a timely basis and clear as many rebates, discounts or short payments as soon as practically possible.

### **Financial impact of selling on promotion**

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 prices.

A winery selling wine on promotion will generally have to sell between 50% and 100% more wine by volume to achieve the same dollar contribution to their gross margin.

### **Cost implications**

Wine businesses must have a detailed understanding of cost structures at every level when considering major retail chains. Selling significant volumes through the supermarket channel is heavily impacted by competition from major wine businesses that have large-scale production facilities in excess of 75,000 tonnes capacity. These businesses can generally produce more than 70,000,000 litres of wine at an overhead cost of less than \$0.25 per litre and a grape cost of under \$0.50 per litre (or approximately \$350 per tonne).

When considering the cost of producing a 9 litre case of wine, the major wine business can have a cost advantage of between \$2-\$4 per case over that of smaller scale operations which is critical if attempting to compete in the supermarket sector at the sub \$7 per bottle segment.

# 5. Managing vintage: grapes, costs and inventory

The grape supply strategy and managing vintage variation are important factors for any large wine business.

The transition from a medium to a large wine business provides a supply challenge. The agricultural nature of the supply side of the wine sector delivers raw material variation that can be as significant as 70% in extreme circumstances but is more likely to be in the vicinity of 20 to 30% in any given year. This creates a supply challenge both in relation to quantity and quality of grapes.

The 15 year period from vintage 1993 to vintage 2007 has seen the industry go from balance to undersupply to balance to severe oversupply and heading back toward balance, notwithstanding structural considerations between cool and warm climate fruit.

This cycle has included anything from wine businesses 'over-committing' to long term supply contracts to wine businesses using legal clauses to exit contracts early. The challenges facing wine businesses are amplified by the cyclic nature of supply.

The supply challenge can be separated into two specific areas:

- securing a supply of higher quality grapes to match higher price brands. The focus is very much an issue between security of supply at sustainable prices for winemakers and grape growers to ensure quality expectations for higher priced brands are not compromised; and
- developing a supply equation for grapes that are destined for the sub \$10 per bottle range. A 500,000 plus case brand requires more than 6,000 tonnes of grapes, equating to more than 250 hectares of grapes. Wine businesses with a high quantity brand have a particular challenge in managing supply to ensure adequate and reliable volume and quality of grapes are available to support the brand.

Most wine businesses support their higher price point brands through a combination of estate vineyards and long term contracts with experienced, high quality third party growers in the required regions. It is unlikely that the spot market or the bulk wine market will be a viable supply strategy for higher priced wines.

Lower price, high volume wines generally require a supply strategy based on a combination of contracts with third party growers and bulk wine companies as well as operating in the grape and bulk wine spot markets.

It is important for large wine businesses to have a well defined supply strategy which clearly identifies the sources for grapes and bulk wine and identifies contingencies for the inevitable vintage fluctuations across quality and quantity. Modelling the supply needs for the business must include the impact of vintage variations and associated cost fluctuations.

The best performing large wine businesses have a strong, well documented strategy for managing supply. This allows them to minimise the impact of a poor vintage and to avoid accumulation of excess supply in larger vintages.

The following section is an analysis of the cost components in producing a case of wine as presented in the **Ready Reckoner** plus commentary regarding the management of inventory levels.

## 5.1 Costs of production

### 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.

With many grape varieties in over-supply in recent years, grapes have been obtainable at prices as low as \$200 per tonne. The **Ready Reckoner** ignores such anomalies and provides a more sustainable cost of grapes for each retail price point. 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.

Wine businesses choose the desired wine region and variety and the **Ready Reckoner** will source the estimated average price for 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 prices 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.

### B. Extraction rates

The extraction rate for grapes depends on many factors including wine production facility, grape variety and intended price point. The model 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 to the **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

Processing costs should capture all wine related costs including labour, overheads and depreciation.

Wine production facilities with an annual crush in excess of 80,000 tonnes incur processing costs on average of 25c per litre (or around \$190 per tonne).

The average processing costs for large wineries (more than \$20 million case sales revenue) from the **Wine Survey** was, on average, 36c per litre (\$270 per tonne).

Processing costs in the **Ready Reckoner** have been set at \$0.50 per litre for large wineries (Revenue greater than \$20 million and a production facility of 7,000 to 50,000 tonnes). The model defines major wine businesses (at least one production facility of greater than 75,000 tonnes) to have a production cost at \$0.25 per litre. These costs are based on the **Wine Survey** as well as observed industry standards and can also be manually changed. They are also indicative of full capacity processing and would be higher in years of short grape supply in particular.

Many wines are not sold in the year of manufacture and the Cost of Goods Sold should also reflect interest (or finance costs) – included as a separate section below.

#### **D. Storage and handling costs**

The significant costs associated with storing wine are often not separately or accurately identified.

The **Ready Reckoner** assumes a rate of 1.5 cents per month per litre for large wineries.

Wine that requires special care and handling may cost significantly more than this amount. However, the majority of higher price wines requiring this level of care should generate sufficient margin to justify the additional costs.

#### **E. Finance costs**

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

#### **F. The cost of oak**

Oak maturation is a relatively small cost for higher volume lower priced wine as it does not normally undergo barrel fermentation.

Oak costs have been separated in the model, based upon the expected number of months in barrel and the type of oak or cost of barrels used to enable a more accurate portrayal of total costs. The separate area of 'Holding Costs' accounts for storage time in tanks or bottle before sale.

The financial effects of maturation have been explained through a separate case study 'Costs of Wine Maturation'.

#### **G. 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.

Many large wineries operate their own bottling lines and the best performing wine businesses can reduce their packaging costs to as low as \$10.20 per case (Source: **Wine survey**).

Large wineries that contract out their bottling and packaging tend to pay between \$13 and \$15 per case for packaging.

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

#### **H. The value of grapes from owned vineyards**

Most large wineries who own vineyards have been applying the Self Generating and Regenerating Assets (SGARA) Accounting Standard for several years. The Standard applied from financial years ending on or after 30 June 2001 for all reporting entities and required grapes and vines to be measured at market value.

While the name of the Standard has recently changed to 'Biological Assets' with the adoption of International Accounting Standards, the requirements have not changed, other than for companies who have operating leases (as defined in the Australian Accounting Standards) over vineyards. The most common example of an operating lease is where wine businesses sell a vineyard to an operator such as the Beston Wine Trust, and lease back the vineyard. The Biological Assets Standard does not apply in these circumstances.

The Standard has the effect of bringing the cost of grapes to account at market value, rather than actual costs incurred in operating the vineyard. The resulting profit or loss is recorded in the year the grapes are picked.

This isolates the vineyard profit and aligns the cost of fruit with wineries that do not own vineyards. All wine inventories incorporate grapes at market prices.

## 5.2 Inventory

A critical challenge for medium and large wine businesses is the management of inventory levels and the constant need to match demand for wine to the supply of grapes and wine.

Where a wine business produces inventory in excess of the volumes required to support its brand portfolio, the company must develop a strategy for utilising that excess production. There is a significant risk to the brand value if the company increases the volume of its major brands and then is forced to discount to sell the increased inventory. This issue is discussed in some detail in the small wine business benchmarking guide. The key issue for a large wine business is that the sheer quantity of excess production creates a magnified challenge. It is therefore critical that inventory levels are managed against a strategic supply plan. This is discussed below.

### Managing inventory levels

The best performing large wineries use the following tools to manage inventory levels and minimise any inventory write-offs:

- vintage plan;
- managing supply surplus and deficit;
- blending; and
- creation and management of disposable brands.

Each aspect is discussed in more detail below.

#### i. Vintage plan

The best performing large wineries utilise a vintage plan to manage grape intake. This identifies the grape varieties and tonnes to be received over future vintages (up to 5 vintages is best practice) and compare the supply to forecast sales by variety.

Best practice vintage plans also split the grapes between the price segments – from basic to super premium and above – to identify shortages and excesses by variety and by segment.

Wineries attempting to reduce identified excesses for coming vintages can use a range of methods such as sale of bulk wine or grapes, launching new products or reductions in future intake through expiration or cancellation of grape supply contracts.

Sensitivity analysis should be performed on the basis of potential vintage variation up or down by up to 30 percent of average yields, or sales variations of 10 to 20 percent higher or lower than forecast. Alternative strategies can then be developed for such scenarios.

#### ii. Managing supply surplus or deficit

The best performing large wine businesses manage inventory by identifying all parcels of wine that are destined for customers based upon historical sales plus sales forecasts and budgets. All such wine is determined as being 'allocated' and the remaining wine is 'unallocated'.

The wine business then considers unallocated wine, which is often split by vintage and variety, and new strategies are developed to sell the wine.

The management of surplus or deficit wine runs in conjunction with, and is often included in, the vintage plan.

#### iii. Blending

Blending is an important part of the operation of any large wine business and it is a fundamental tool in managing the surplus or deficit position.

The blending requirements under the Australian Wine and Brandy Corporation Regulations allow up to 15% of a different variety or vintage to be blended into a particular wine.

The blending of excess wine into current brands will assist in minimising the impact of selling bulk wine. Bulk wine sales are often at much lower margins than branded wine and can be at below cost during extreme circumstances of excess supply.

#### iv. Creation and management of disposable brands

A strategy that has been successfully utilised by some wine businesses is to develop disposable brands to manage higher than required inventory levels. A disposable brand is a non-core range which is generally a blend of excess wine from branded product. It is important to note the product must maintain all the same principles underlying any brand development including a selling differential. These brands are usually pitched at relatively low prices and are used to assist in the orderly disposal of excess production.

There is a limit to the amount of wine that can be sold through a disposable brand, and it is often something that can be offered through a wine club, or to “wine disposal” businesses, such as ‘discount’ online wine sites.

#### Inventory and working capital ratios

The following table shows the inventory and working capital ratios for best performing large wineries.

Table 5: Inventory and working capital ratios – best performers

Inventory and working capital	\$20 million+ Average 2005	\$20 million+ Best 2005
Inventory to COGS	1.70	1.74
Inventory Turnover	0.62	0.67
Working capital to sales	1.13	1.01
Working capital to COGS	1.83	1.81
Non-current Inventory %	38%	34%

#### Inventory ratios

The proportion of non-current inventory held by the average large winery is 38% of total inventory, compared with 34% for best performing large wineries.

The ‘Inventory to COGS ratio’ suggests that large wineries are holding 1.70 to 1.74 years of cost of sales as inventory.

#### Working capital ratios

For every \$1 increase in sales, \$1.01 to \$1.13 of working capital will be required. That is, a \$100,000 increase in sales will require just over \$100,000 in working capital. This can have a significant impact on cash flows when a business is growing.

The medium wine business guide has a significant discussion on the impact of working capital on a growing wine business and these issues are similar for a large wine business.

# 6. General and administrative 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 audit and tax fees, consultancy, office costs, computer software expenses, postage and printing, salaries (excluding cellar, winemaking and sales and marketing salaries) and other general expenses.

General and administrative expenses in the Gross Margin Ready Reckoner assume a sustainable level of 12% of revenue for large wine businesses.

## Foreign exchange

As discussed earlier in the report, a high proportion of sales of large wine businesses are through the export sales channel. This often exposes large wineries to foreign exchange risk in relation to exports which are not transacted in Australian Dollars. The main exposure is to the key export markets of the US and UK through movements in the USD and GBP.

Historically, there have been significant fluctuations in the ratio of the AUD to the GBP and the \$US.

Many large wine businesses hedge their exposure by entering into Forward Exchange Contracts to lock-in a forward rate for sales made in foreign currency.

However, it should be noted that recent changes to Australian Accounting Standards have made it increasingly difficult to record such hedges as specific hedge transactions, potentially resulting in sharp movements in the Income Statement each year. Specific and general hedges are discussed below.

## Example: Hedge accounting – Specific versus General Hedges

With the recent adoption of Australian Equivalents to International Financial Reporting Standards (A-IFRS), the requirements to record hedge transactions as specific hedges have become much tighter.

The benefit of recording specific hedge transactions is that it allows the winery to delay the impact of the movements in foreign exchange until the transaction is settled. The movement in the AUD value of the foreign currency item (that is, the amount receivable in USD) can be matched against the hedged item (that is, forward contract to sell USD), minimising the financial impact and reducing foreign exchange risk.

However, if hedge transactions are recorded as general hedges, effectively making them a speculative transaction, the winery is required to calculate the gain or loss on the hedged item (such as the contract to buy USD) and the foreign currency receivable at each reporting date and account for any gain or loss in the Income Statement. As forward exchange contracts are often taken out months in advance of the settlement of a transaction, it is common for a half year or year end reporting period to fall between taking out the forward contract and the settlement of the transaction.

This can therefore have the effect of recording large gains or losses in the Income Statement at reporting date which are simply risk management movements that will balance out at the time the sale transaction is completed.

You should consult your financial advisor to fully understand the requirements and implications of accounting for hedging transactions under A-IFRS.

# 7. Balance sheet structure

The way in which a wine business structures its business will affect its profitability and cash flows.

The table below provides one model of the Balance Sheet structure of a large wine business. The basis of preparation of these balance sheets is set out in the assumptions following the table. When analysing 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. This could include 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 fluctuations through the course of the year.

Table 8: Balance sheet

2005	Best Performers \$20 million+		Benchmark Median \$20 million+		High Volume/ Low Margin \$20 million+	
	\$ Million	% revenue	\$ Million	% revenue	\$ Million	% revenue
<b>Assets</b>						
<b>Current assets</b>						
Cash	0.0	0.0	0.0	0.0	0.0	0.0
Receivables	5.9	16.4	5.9	16.4	5.9	16.4
Inventories	27.5	76.4	26.1	72.5	28.9	80.4
<b>Total current assets</b>	<b>33.4</b>	<b>92.8</b>	<b>32.0</b>	<b>88.9</b>	<b>34.9</b>	<b>96.8</b>
<b>Non current assets</b>						
Land	1.5	4.1	1.1	3.0	1.1	3.0
Vineyards	12.3	34.1	9.9	27.5	9.9	27.5
Buildings and improvements	0.8	2.3	0.8	2.3	1.4	4.0
Plant and equipment	9.2	25.5	9.2	25.5	19.6	54.4
<b>Total net fixed assets</b>	<b>23.8</b>	<b>66.0</b>	<b>21.0</b>	<b>58.3</b>	<b>32.0</b>	<b>88.9</b>
<b>Total assets</b>	<b>57.2</b>	<b>158.8</b>	<b>53.0</b>	<b>147.2</b>	<b>66.9</b>	<b>185.7</b>
<b>Liabilities and equity</b>						
<b>Current liabilities</b>						
Notes payable and bank debt	7.3	20.2	6.5	18.0	16.3	45.2
Provisions	0.1	0.4	0.2	0.6	0.4	1.1
Trade payables and accruals	5.9	16.4	5.9	16.4	5.9	16.4
<b>Total current liabilities</b>	<b>13.3</b>	<b>37.0</b>	<b>12.6</b>	<b>35.0</b>	<b>22.6</b>	<b>62.7</b>
<b>Non current liabilities</b>						
Long term debt	28.9	80.3	26.9	74.7	34.7	96.3
Non-current provisions	0.2	0.5	0.3	0.8	0.5	1.3
Deferred tax liabilities	0.0	0.0	0.0	0.0	0.0	0.0
<b>Total Non-current liabilities</b>	<b>29.1</b>	<b>80.8</b>	<b>27.2</b>	<b>75.5</b>	<b>35.2</b>	<b>97.6</b>
<b>Total liabilities</b>	<b>42.4</b>	<b>117.8</b>	<b>39.8</b>	<b>110.5</b>	<b>57.8</b>	<b>160.3</b>
Equity	14.8	41.0	13.2	36.7	9.1	25.4
<b>Total liabilities and equity</b>	<b>57.2</b>	<b>158.8</b>	<b>53.0</b>	<b>147.2</b>	<b>66.9</b>	<b>185.7</b>
<b>Ratios</b>						
Return on Assets (ROA) after tax		6.6		2.9		(0.8)
Return on Equity (ROE) after tax		25.6		11.4		(5.9)
Debt/Equity		245.1		252.6		557.1
Working Capital		250.1		254.0		154.4

Note: figures presented 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 Table 3;
- ii. sales channels are approximated as the percentages listed in Chart 5;
- iii. debtor days – 60;
- iv. creditors assumed to be basis for funding debtors thus cancelling the two figures;
- v. % of Grapes from own estate – 37.5%, 30% and 16% for each category;
- vi. inventory is treated a current;
- vii. inventory turnover – 1.5, 1.25, 1.2 for each category;
- viii. debt levels are based on funding of assets such that 50% of inventory is funded by debt, 60% of vineyards are funded by debt and 90% of plant & equipment is funded by debt;
- ix. vineyards are valued at \$55,000 per hectare of developed vineyard, including land;
- x. buildings, Plant & Equipment are assumed at a cost of \$1,250 per tonne capacity ;
- xi. operations are assumed to be at approximately full capacity;
- xii. there is no contract processing; and
- xiii. there are minimal bulk wine sales except for last category.

The key aspects to consider when looking at the above balance sheet, and analysing individual enterprise balance sheets, are:

1. the model shows for both wine business sizes a debt/equity ratio of approximately 240-250% for the best performing wine businesses. This ratio provides a reasonable balance between return on equity after tax being a relatively conservative 8-12% and the ability to withstand the pressure caused by vintage fluctuations on lending covenants imposed by banks. When this is compared to the high volume/low margin producer the ratio increases dramatically to 550-560%. This clearly will put significant pressure on banking covenants, particularly those covenants based on debt to equity ratios and EBIT or EBITDA to interest ratios. This could hamper these companies with growth and / or sustainability issues;
2. the working capital ratio for the average and best performers is around 250%, which is consistent with the needs of a company that has a requirement to hold inventory for an extended period of time. This is compared to the high volume/low margin producer which holds inventory for a shorter period of time. It should also be noted that the working capital needs for all wine businesses is extremely seasonal and that when considering the needs of an individual business, this seasonal fluctuation must be carefully modelled to ensure banking or finance facilities can be structured around seasonal needs;
3. the equity level for a large wine business assumes a significant level of retained profits. These profits will generally have been generated over time. Absence of retained profits will require equity from other sources to support the level of borrowings. The funding of growth by a large wine business through raising capital, either from existing shareholders, new private investors, private equity funds or the capital markets is an important consideration for all large wine businesses. The decision on which option best suits a particular wine business is not simple and requires careful strategic planning in relation to the future direction and objectives of the business and its current shareholders;
4. wine businesses are very 'Asset' intensive. The large wine business structures above have total assets ranging from 145% to in excess of 185% of case sales revenue. It should be noted that the benchmark for the best performers is around 150% and that in calculating this ratio the model has assumed replacement cost for all plant and equipment and Market/Fair value for vineyard assets; and
5. the model demonstrates the significant challenges faced by the high volume/low margin producer. The financial pressure placed on the business by low profitability, combined with the balance sheet pressure of excessive debt to equity and working capital limitations, tells a compelling story that questions the sustainability of this strategy in the medium to long term.

## 7.1 Infrastructure transactions

The management of infrastructure assets such as wineries and vineyards are a critical component of the structure of large wine businesses. Grape supply is managed by a combination of owned vineyards, third party grower contracts and third party spot purchases. Wine manufacture is managed by a combination of owned winery assets, contract wine making, bulk wine contracts and third party spot purchases of bulk wine. Many large wine businesses choose to also manage infrastructure assets by way of sale and leaseback transactions. Historically this has been mainly in relation to vineyard assets; however there is a trend in recent years to also apply this strategy to winery assets.

Most of these sale and leaseback transactions have been structured such that the original operator receives the produce or output (such as grapes or wine processing in the case of a vineyard or wine business sale) of the asset and also maintains a strong level of quality control by having employees in place at the asset site (vineyard or wine business).

In relation to a sale and leaseback of a wine business, while ownership and the capital risk and benefits (being the potential increase or decrease in value of the wine business) transfers to the lessor, the lessee enters into a long-term contract to process their grapes at the wine business. Such clauses can be incorporated into the sale contract to require the lessor to employ the lessee's winemaking team at the wine business as well as any other factors considered necessary to maintain wine quality and ensure a trading preference.

The financial benefit for the operator is to free up capital for business development and expansion.

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This document – Version May 07, was prepared by Deloitte Touche Tomatsu for the *Wine Australia: Directions to 2025* project with overview from the Winemakers' Federation of Australia and Australian Wine and Brandy Corporation.

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