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Winery Valuations: Six Questions to Ask When Analyzing Operations and Cash Flows

By Christopher Meineke, CPA/ABV

For most professionals, working in the wine industry sounds like a great opportunity. Wineries appear sexy, sophisticated, and elegant, and they offer interesting site visits. Plus, there is the intriguing thought of performing a little quality control testing to ensure the wine is as good as the owners say. Despite the aura surrounding the wine business, there are many issues to consider before taking on a winery valuation engagement. The goal of this article is to cover some wine industry basics and to offer helpful tips on areas that are not as cut and dried as they may seem.

Winery types. There are two primary types of wineries: an integrated winery and a negociant winery. Both types can vary in size and organization structure, and each has its own advantages.

An integrated winery farms grapes to be used in its own wine and typically has a physical winery property along with vineyards that are either owned or leased. This type of winery may also purchase additional grapes to be used in producing its wine. Many integrated wineries are "estate wineries" that only produce wines farmed from their own vineyards. Wineries that farm their own grapes have better control over quality but can be more susceptible to agricultural risks and economic cycles.

A negociant winery is one that buys grapes or bulk wine from others to use in its own label. Negociant wineries have more flexibility in their operating structure and can more easily adapt to changes in the economy.

Regardless of the type of winery you're valuing, its operating and organization structure can have a significant impact on its cash flows and the resulting value to prospective buyers. It can also have a significant impact on the amount of work required for a valuation engagement. Here are six questions that will help you decide how to plan and execute a winery valuation engagement.

1. Are the books maintained on a cash or accrual basis?

There are many differences in winery accounting depending on the basis of accounting used. The decision impacts all three primary valuation approaches (income, asset, and market). If a winery only files a tax return, it will often use a cash or tax basis of accounting. Of course, this will result in significantly different asset, liability, and net income (loss) calculations than generally accepted accounting procedures (GAAP). Items that may require adjustment due to a tax or cash basis of accounting are as follows:

- Accounts receivable and payable;
- Depletion allowances;
- Deferred farming costs;
- Inventory (covered in more detail later); and
- LIFO adjustments.

2. What inventory costing methodology is being used?

Inventory is one of the biggest challenges to comparability when analyzing wineries. As noted above, a winery's choice in inventory costing methodology will significantly impact its net income and profit margins. Here are some of the more common costing methodologies.

A winery can use a traditional first-in, first-out (FIFO) costing methodology. In this scenario, the winery accrues all expenses and allocates the cost of grapes, bulk wine, production costs, bottling materials, and indirect costs to the bulk and bottled wine inventory. The costs are accumulated in inventory until the wine is sold and the costs of the specific individual cases of wine are transferred to cost of goods sold.

Wineries can also cost their inventory using the last-in, first-out (LIFO) methodology of inventory costing. When using LIFO, a winery costs its inventory in the same way as using FIFO, but when transferring costs to the income statement, it uses the last case of wine produced to determine the cost of goods sold. This has many tax advantages and can dramatically impact profit margins, as it is susceptible to large swings—especially with estate vineyards. When valuing a winery that uses LIFO, you should analyze profit margins using FIFO costs of goods sold, as this is more reflective of what's actually happening from year to year in winery operations. Wineries using LIFO will generally use FIFO for in-house analysis, making the numbers easily available.

Often, wineries will use a different inventory costing methodology for tax returns because there are various benefits. For example, if the winery owns or leases its vineyards, on its tax return, it can expense its farming costs in the year incurred rather than capitalizing them into inventory. Or, if the winery has below one million dollars of average revenue, it may be eligible to expense certain costs rather than capitalizing them into inventory. When analyzing a winery that only files a tax return, you will need to fully understand its costing methodology and account appropriately for it in your analysis.

Due to the use of differing accounting methods, as noted above, for tax returns and financial statement presentation (e.g., LIFO versus FIFO method of valuing inventory), it can be challenging and often ineffective to compare a winery to

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industry averages from data providers from a purely financial perspective.

3. Where does the winery source its grapes?

An estate winery, as noted above, farms its own grapes and takes on a significant amount of agricultural risk (due to weather, disease, pests, etc.) in addition to the risks of manufacturing wine. The winery's vineyard yields (tons per acre) will greatly impact its cost of sales and profitability. Vineyard costs in total are generally stable from year to year, but when vineyard yields decline or increase, the costs of producing wine can vary significantly. The agricultural aspect also makes it difficult to project future inventory availability and working capital requirements

Wineries that purchase their grapes from others usually have a fixed cost per ton based on factors agreed to in a grape contract. Fluctuations in yields may still impact costs from a supply perspective, but grape costs per ton are fixed. Cost per ton for grapes is based on factors such as vineyard appellation (see the sidebar), farming practices, and quality of fruit. Changes in the bulk wine market will impact negociants using bulk wine to make their product.

When dealing with related-party grape purchases, you should analyze the purchase cost per ton to ensure it's at fair market value. A willing buyer is not going to receive the same discount on grapes and will have to pay market value for future grape purchases. For California grape purchases, we use the *California Final Grape Crush Report* released by the California Department of Food and Agriculture to estimate fair market value. This report lists grape prices by district and variety.

Valuing a Winery's Appellation Can Trigger Tax Savings

In business, location can mean everything. Grapes and wine from well-known locations, known as "appellations" or American Viticultural Areas can bring higher prices than those from non-AVA areas. An AVA is a grape-growing region defined by the federal Alcohol and Tobacco Tax and Trade Bureau. An AVA has value, and it can be amortized for tax purposes. But many wineries have not carved out the value, so they have not been reaping the tax savings.

Dying on the vine. In 1993, Section 197 of the Internal Revenue Code was enacted, providing for a 15-year amortization period for certain intangible assets. It wasn't clear whether appellation rights qualified under this section, and some wineries did not allocate purchase price to the value of the appellation. In 2010, the IRS released a chief counsel memorandum (GCM 201040004) concluding that an appellation right does qualify as an amortizable asset under Section 197. But some wineries have yet to act on this and may be missing out on tax savings. That's where the valuator comes in.

For example, on Jan. 1, 2008, Acme Winery bought a vineyard for a total of $10 million. Value is assigned to depreciable assets (buildings, vines, trellises, and the like), and the balance of the purchase price is allocated to land. The value of the existing appellation was buried in the value of the land. As a result, no tax deductions were taken on the appellation value. Fast forward to present day, and a valuation expert determines that the fair value of the land acquired included appellation rights of $3 million.

Because Acme bought the vineyard after the effective date of Section 197 (Aug. 10, 1993) and did not assign value to the appellation, it can take an annual tax amortization of $200,000 over a 15-year period. Better still, Acme may be allowed to make an automatic change in accounting method. If that's the case, it can deduct, in the year of the change, 100% of accumulated amortization related to the appellation right. That is, it can take catch-up deductions for prior years and take the remaining unamortized amounts in future years. Assuming a top corporate tax rate of 35% and top individual rate of 39.6% for flow-throughs, the total $3 million of deductions would trigger tax savings of over $1 million.

What to do. When analyzing a winery, investigate whether there is an appellation right to be valued. Any untapped tax savings will affect the valuation, of course. To claim a deduction, however, a competent, well-supported valuation of the relevant vineyards is crucial.

4. Are winery and vineyards leased from a related party?

This can be one of the more challenging assessments, so it shouldn't be taken lightly. Related party leases are often below fair market value, and adjustments can be significant. Unfortunately, there is no industry standard for vineyard leases and there are many factors that influence value. To analyze this aspect of a winery, it helps to have industry experience and/or relationships with land appraisers and lawyers in the area.

5. What are future capital requirements?

Wineries need a lot of operating capital due to the cost of grapes, barrels, equipment, and facilities for producing wine. In addition, wine is often aged for years in barrels (red wine more than white wine) that are located in temperature-controlled facilities before being released. The aging process requires several years of investment before any cash return is realized.

When looking at forecasts, it's necessary to make sure a winery's capital needs match its production goals. Increasing production requires more capital for grapes, barrels, and labor—plus a significant amount of cooperation from nature.

6. Is the winery's forecast reliable?

When looking at forecasts in any valuation, reliability is something you have to keep in mind. Reliance on a winery's forecasts is made even more problematic due to the agricultural component and the variability of grape crops. One poor crop will destroy the most well-prepared forecast and cause production costs to soar.

Pay close attention to the following management assumptions in a winery forecast:

- Cases sold—Is this consistent with the amount of inventory currently available for sale? How is the winery going to make up for any shortfalls in inventory if there is not enough supply?

- Gross margins—Are these reflective of the current costs already incurred for bulk and bottled wine on hand? Will the winery be increasing prices or changing its discounting practices?

- Vineyard yields—These can vary greatly, so you may have to go beyond comparing with past performance. It can be valuable to talk to the vineyard manager and look at grape forecasts from industry experts. You will want to inquire whether any new vineyards are going into production, as this may impact available grape supply.

- Sales and marketing costs—Do these costs make sense for a winery given its current or future size? A winery trying to expand production and sales will likely require a larger sales force.

- Sales channels—Is the winery focusing on a new sales channel? Many wineries now focus on direct-to-consumer sales due to higher profitability but set unattainable goals and have no real plan to achieve them.

The wine industry is a uniquely challenging area to provide valuation services. It encompasses aspects of farming, manufacturing, distribution, and retail industries. For a business valuation expert, entering into an engagement with the right information can be the difference between a successful engagement and one that is "corked."

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