MKF RESEARCH

ASSESSMENT OF THE PROFITABILITY AND VIABILITY OF VIRGINIA WINERIES

PRESENTED TO THE SECRETARY OF AGRICULTURE AND FORESTRY OF VIRGINIA

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TABLE OF CONTENTS

EXECUTIVE SUMMARY

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

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

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

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

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

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

OBJECTIVES

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

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

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

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

MEASURING PROFITABILITY AND VIABILITY

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

Gross Margin

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

Net Income/Loss

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

Return on Assets

Return on assets is the net income or loss divided by total assets. This provides an indication of how hard the assets are working for the business. Underutilized assets will lead to a smaller return on assets. Since the wine industry is asset-intensive, these returns are generally small, except when a winery leverages facilities or equipment of other wineries or services.[1]

FACTORS AFFECTING PROFITABILITY AND VIABILITY

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

General Business

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

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

Capitalization

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

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

Professionalism

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

Business Planning

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

Business Focus

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

Recordkeeping

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

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

Operations

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

Facility Maintenance

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

Supply Chain Management

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

Varietal Focus

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

Asset Utilization

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

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

Distribution

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

Three-Tier Distribution

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

Self Distribution

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

Wine Club or Mailing List

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

Wine Festivals

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

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

Retail Location

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

Tasting Room Location

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

Satellite Retail Locations

Wineries with vineyards which are not easily accessed can set up *satellite retail operations* as a way of selling wine directly to consumers in a location more accessible. While some wineries take advantage of this option, many more should seriously consider this. Co-op tasting rooms are popular in many states whereby a group of small wineries band together to open a joint tasting room at a strong location, sharing in the startup and operational costs.

Concentration of Wineries

Many wineries in Virginia struggle to attract large numbers of visitors due to a lack of *concentration of wineries*. Groups of nearby wineries can attract winery visitors intent on visiting multiple wineries, whereas remote wineries must give the visitors a reason to make the specific trek.

County Use Permits

County use permits have been controversial recently as a result of the encroachment of suburban communities into traditional farm country. There is concern from some wineries about having their ability to host customers for a variety of events limited to some degree by their county. We did not become aware of any specific situations where a tasting room activity has been disallowed. Instead, current restrictions generally are limited to constraints on numbers of visitors or scale of events. Whereas these constraints certainly have a negative impact on winery profitability, they shouldn't necessarily have an impact on winery viability, depending on the scale of activity allowed. However, there is concern by some winery owners that future county permit restrictions could be more prohibitive, potentially impacting winery viability.

<table>
<tr><th colspan="2">Factors affecting profitability</th><th>What profitable wineries do</th><th>What unprofitable wineries do</th></tr>
<tr><td rowspan="4">Retail location</td><td>Tasting room location</td><td>Locate tasting room in high traffic area</td><td>Locate sole tasting room in remote location</td></tr>
<tr><td>Satellite retail locations</td><td>Utilize satellite retail locations to expand exposure</td><td>Don't establish a satellite retail location</td></tr>
<tr><td>Concentration of wineries</td><td>Encourage neighboring wineries</td><td>Locate sole tasting room in remote location</td></tr>
<tr><td>County use permits</td><td>Develop cooperative programs</td><td>Create conflict</td></tr>
</table>

Cost Control

Several factors affecting winery profitability and viability involve controlling costs. These include grape costs, labor costs, family labor, selling and marketing and administrative costs.

Grape Costs

Grape costs in Virginia are generally fairly expensive compared to other states (see the discussion in ***Vineyard Profitability*** section ahead). Some wineries import similar quality grapes from other states at lower prices. Given the relatively high cost to buy or grow grapes in Virginia, it is critical that growers raise varieties that are best suited in cost and quality to each vineyard site.

Labor Costs

Labor costs are not consistent from winery to winery in Virginia. There are some with a large number of employees paying a significant amount in labor costs and others utilizing owners or family members as "unpaid labor," giving the illusion of increased profitability. We found a large range in the number of employees without much differentiation in the amount paid per employee. Some wineries utilize a very thin staff level with the owners significantly involved. Overall, the amount of labor seemed reasonable, although there were some which use a surprisingly high number of employees.

Selling and Marketing Costs

For successful wineries, selling and *marketing costs* generally represent between 20-30% of sales revenue. Most of the sample of wineries surveyed could not specifically identify sales and marketing costs. Of those which could, most either fell within the range above or were actually even lower. Salaries for sales people are often a large component of selling and marketing costs. Generally, Virginia wineries need fewer dedicated sales people as a large percentage of wine is sold to local markets or direct to consumers instead of through wholesalers. Also, in smaller operations, the proprietor (who may not be getting paid a salary) is usually responsible for sales and marketing.

Administrative Costs

Administrative costs in successful wineries generally run between 10-15% of sales revenue. Oftentimes, the cost to administrate a 5,000 case winery is not that different from a 30,000 case winery. Therefore a 5,000 case winery selling wine at a relatively low price point will have a difficult time optimizing administrative costs. Small wineries in Virginia doing a good job of limiting administrative costs either utilize owners to perform a lot of the work or combine the administrative function with other family businesses. Administrative costs did not appear to be unnecessarily high in any of the wineries for which we received this data. However the modest level of administrative costs may reflect underinvestment in business planning and data collection and becomes a counterproductive solution to achieving profitability.

BROAD CATEGORIES OF WINERIES

There are over 120 farm wineries in the state of Virginia. MKF Research, LLC met or spoke with representatives of a representative sample of these wineries. Our sample of wineries included wineries of all sizes from all regions of the state.

We have identified five broad categories of wineries. These are as follows:

- Large: Wineries producing in excess of 25 thousand cases annually, the majority of which is sold through three-tier distribution channels;
- Small and Business-focused: Small wineries with a well-thought-out business plan;
- Small and Undercapitalized: Small wineries without the necessary capital resources to grow or make necessary improvements;
- Small Farmers: Small wineries originating from the need of related vineyards or orchards to sell fruit; and
- Tourist Venues: Wineries where wine is secondary to other events or activities.

Even though we identified these rough groupings, it seemed like every business we researched had something that made is unique and different from other Virginia wineries. There are definitely some wineries which are difficult to categorize. Many of the smaller wineries could actually fit into multiple categories.

Large Wineries

Virginia wineries producing in excess of 25 thousand cases had many similar characteristics. Given their size, a majority of their wine, typically between 70 and 80 percent of total case volume, is sold through the three tier distribution channel. Most of this wine remains in the state, with a couple of the wineries selling wine to targeted markets out of state. Many of these large wineries had multiple labels or product lines with at least one premium label made in smaller quantities and at least one less expensive label made in larger quantities. These large wineries are generally more sophisticated than the smaller wineries and usually run as sound businesses, being well-capitalized, professional and reasonably well-planned. The large production volumes typically encourage variety in products rather than specialization, but it doesn’t negatively impact the businesses. Self-distribution is not an issue with large wineries as they need to work with distributors given the large volume of wine to distribute.

The retail locations of the large wineries are either near high-traffic roads or in tourist areas. They do not have a difficult time attracting large volumes of visitors. Some retail locations are located far from the nearest competing winery, although most of the benefit of being located within a concentration of wineries would go to the smaller wineries, which take advantage of the draw of the larger winery.

The scale of the large wineries allows them to run more cost effectively than the smaller wineries. Whereas marketing costs as a percentage of sales may be comparable to smaller wineries, production and administrative costs generally benefit from economies of scale. Buying winemaking and bottling supplies in larger quantities also allows for price breaks.

Based on the wineries we researched fitting into this category, each appears to be currently profitable and, more importantly, viable for the long-term.

Small, but Business Focused Wineries

Several of the small wineries we contacted were run impressively, exhibiting many of the qualities of profitable wineries listed in the tables in the previous section. Many of these wineries established solid and realistic business plans before getting into the business.

These wineries had the same business management discipline of the larger wineries and it was demonstrated in their financial results. These wineries have taken advantage of things like developing wine clubs, setting up a related-party wholesaler to circumvent the self distribution limitation, establishing satellite retail locations to reach a wider consumer base, managing supply to meet demand through changing product mix as necessary or remaining flexible by purchasing bulk wine to increase volume, and managing payroll and other costs to reasonable levels. These wineries appear to be viable businesses going forward.

Small and Undercapitalized Wineries

There was a small group of wineries which do not have sufficient capital resources to support future expansion or, in some cases, operations. Bank financing is difficult to obtain as not many area banks are familiar enough with the nature of the industry. Unless there are significant assets to serve as collateral for loans, local banks are reluctant to provide funding. In general, these wineries are not viable businesses going forward. Some continue to exist purely as personal interests.

Small Wineries Started by Farmers

Under the category of small wineries started by farmers, there is actually quite a broad range of business types. Many of these began as vineyards or orchards on land that has been in the family for multiple generations. Most have located the winery facility and tasting room on the same property as the vineyard. That works well for sales when the location is central or adjacent to other wineries or tourist destinations. If the site is remote, it is difficult to attract consumers. Some wineries take advantage of open satellite retail locations to better access consumers.

In many cases, these wineries have established relationships with local retailers and restaurants. Prior to June, 2006, they were able to self distribute to these retail locations. Now that they have to sell through the three tier distribution system, these relationships have become strained with the introduction of a middleman. Even if they set up a family member as a wholesaler, some retailers are reluctant to work with them due to a lack of understanding of the law. With case volumes relatively low, small wineries cannot afford the higher cost of utilizing a wholesaler to distribute wines locally. This could have a significant impact on future viability. The small wineries which currently sell a substantial portion of their wine through distributors all struggle to achieve profitability and are not considered to be viable.

Labor costs are generally managed fairly well by these wineries. Many of these businesses rely on family labor in the vineyard, winery, tasting room and administration. To the extent external labor is used, it is often a reliable, loyal workforce with even the same seasonal labor returning year to year.

Wineries at Tourist Venues

The final category consists of wineries associated with tourist venues. Whereas some of these are extremely successful at bringing in tourists, the ones whose primary focus is on businesses other than the winery cannot help but have the winery suffer as a result.

INDUSTRY PROFITABILITY TRENDS

Collecting financial information from wineries was challenging as many did not want to disclose the information or did not have good information to disclose even if they wanted to. Based on the information we were able to collect, we developed some Virginia winery benchmarks for the measurement of profitability. As previously mentioned and defined, the metrics we identified as being most tied to profitability were gross margin, return on sales and return on assets.

Gross Margin

In many cases, the cost of goods sold was an estimate and not necessarily consistent from winery to winery. We tried to estimate as consistently as possible.

In our sample of wineries, most of the large wineries were operating with gross margins of less than 50%. Fortunately, the operational efficiency of these businesses allows them to remain profitable despite the low margins. One winery, with much higher margins, also has significantly higher operating expenses.

Most of the smaller wineries reported gross margins between 50-60%. The few above 60% are doing an excellent job. In some cases, the high margins are attributable to extremely low fruit costs. Wineries with a gross margin below 60% when most sales are through high margin retail channels is not a good situation. Either costs are too high or the wines are priced too low. If the winery is unable to sell all its wine through retail channels and has to distribute wine through wholesale channels, the gross margin would drop substantially.

Very few wineries track inventory cost at a product level. Those which are tracking inventory costs typically bundle all costs together to come up with an overall average cost per case or bottle. By taking the inventory costing to a product level, wineries will be able to better evaluate profitability of individual products.

Return on Sales

In profitable wineries, profits exist but typically are not large. Industry-wide, net income as a percentage of sales (return on sales) is usually between 5 and 15%. Most Virginia wineries reporting a profit are reporting a small one, with most less than 5%. There are a few with returns on sales in excess of 10%. Some show a healthy operating income (before interest), but debt service drives net income down to near nothing.

Some wineries had related businesses included in financial information. In these situations, the results varied greatly when the winery business was tracked separately from other businesses. One example showed the winery subsidizing other businesses while another example showed the winery being subsidized by other businesses.

New wineries, even with very sound business plans, typically take more than a couple of years before achieving positive net income or cash flow. Most of the newer Virginia wineries profiled are still experiencing a net loss. This doesn't mean the businesses are not viable; it just takes a little while to build sales to a point where they can sufficiently cover administrative costs.

Wineries in the 8,000 to 12,000 case range often struggle with profitability as it generally takes a similar amount of administrative effort and cost to run a winery of this size as it does to run a 20,000 or 30,000 case winery. The situation is even more difficult when the average sales price per bottle is less than $10. This is generally not a very viable model. It is possible to be profitable selling fewer than 8,000 cases at this price level if virtually all of the wine is sold direct to consumers.

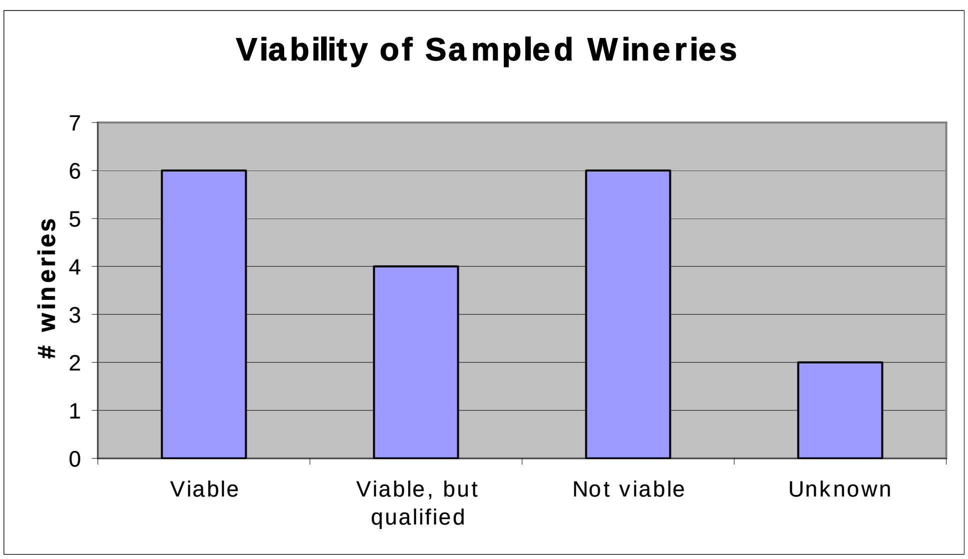
Return on Assets

Industry-wide, return on assets are typically very low, even lower than return on sales. Assets generally represent 1.5 to 3 times sales, therefore return on assets is between a third and two-thirds of return on sales. The wine industry is an asset heavy industry. In addition to fixed assets such as vineyard land, vineyard development, winemaking equipment and barrels, inventory balances are substantial since it often takes more than a year from harvest until bottling of finished goods, and then up to another year to sell through the finished goods.

We did not receive a lot of reliable asset figures from many of the profiled wineries. Of those we received, most fell in the range of between 1.5 to 2.5 times sales, with some well in excess of that range. Some smaller wineries with vineyards had an extremely large investment in assets compared to current sales volumes. All of the wineries we profiled had a significant volume of assets. Virginia has no virtual wineries (wineries producing wine buying grapes and outsourcing the crush and winemaking to a custom crush facility), other than those which are in the process of building a facility.

Winery Assessment

We assessed each of the sampled wineries for viability. We concluded that each winery was either: viable, viable but qualified, not viable, or unknown (if they were very early in their life cycle). Ten out of eighteen wineries (55%) were rated as viable with two others unknown.



We reached these conclusions by reviewing financial ratios, positive and negative factors affecting profitability, and prospects for the future. The rating of some wineries was qualified. For example, one winery's business was only deemed viable because of a related business which had a great impact in helping sell wines. Without that related business, it is likely the winery would not have been considered viable. Another example, representing the opposite end of the spectrum, was a winery that was assessed as not viable since the winery business was not the primary focus of the business enterprise.

MARKETING AND PROMOTIONAL EFFORTS

Many wineries find mass advertising through newspapers, radio or TV is not terribly effective. Research across the country has found that most first-time visitors come to wineries through either word of mouth or by local tourist information. Wine sales and visitors are driven by word of mouth and recommendations from wine store or restaurant personnel. Editorial coverage in the press is far more effective in generating interest than paid advertising.

The promotional efforts of the state's wine industry organizations are helpful to the industry, but there is still much disagreement amongst wineries regarding the content and format of marketing materials such as the Guide to Virginia Wineries. It might be useful for the State to look at the efforts of states in other emerging wine regions, such as New York, where a variety of efforts link promotion of New York wine and food, such a NY Restaurant week, where restaurants offer special menus of entirely New York grown food and wine, as well as many other promotional efforts. Neighboring North Carolina seems to be successful integrating wine into tourism promotion. California is starting a 'rewards' program for winery visitors in cooperation with leading hotel chains.

VINEYARD PROFITABILITY

In general, profitability of vineyards is difficult to achieve. Vineyards producing quality grapes can cost between $1,500 and $2,000 per acre to farm. These costs, plus the amortization of development costs of around $15,000 per acre, result in total farming costs of between $2,500 and $3,000 per acre. With an average yield of 2.5 tons per acre for high quality grapes, the farming cost per ton averages between $1,000 and $1,200 per ton. With Vinifera grapes selling in the neighborhood of $1,300 per ton, profitability is clearly limited. Furthermore, hybrid grapes sell for around $850 per ton, but yields are usually a bit higher and farming costs a little lower. Similar quality grapes can often be found in other states at a lesser price, leading some wineries to source from out of state.

The lack of profitability in farming vineyards and selling grapes leads to many grape farmers opening wineries in an attempt to sell a higher margin product. Unfortunately, many of these farmers may jump into the wine business without adequate planning or commitment. Winemaking is not only a capital intensive undertaking but wine is a consumer product and thus has quite different sales and marketing requirements than grapes.

RECOMMENDATIONS

In researching and summarizing information about Virginia winery profitability and viability, we have developed a number of recommendations, both for the Commonwealth and individual wineries.

Commonwealth

The Commonwealth should encourage winery visitors and sales, especially direct sales. Direct sales, whether to consumers or local retailers and restaurants, are critical to the success of smaller wineries in the Commonwealth and should be encouraged. Winery tourism drives sales direct to consumers as well as consumer education about the industry.

The Commonwealth should continue to strengthen and support viticulture and enology research and education not just for the benefit of the Commonwealth and its wineries but also for the wine industry throughout the East Coast. Furthermore, the encouragement of allied industries such as material suppliers and consultants can help make Virginia a hub for East Coast viticulture and enology.

Finally, the Commonwealth should support and provide access to business planning expertise and training for wineries. There seems to be a real lack of resources in this area and the lack of business planning seems to be a common thread through wineries evaluated as not viable businesses.

Wineries

Virginia wineries should first and foremost work together as a group to present a united front on issues that affect the entire industry. For example, larger wineries should be supportive of smaller wineries in their pursuit of regaining self distribution to local retailers and restaurants.

It seems clear that business planning and management skills could be improved. More winery owners should treat their venture as a serious business. There are a number of specific areas which should be addressed including, but not limited to, long-range planning, understanding customers and product demand, gaining a good understanding of individual product costing and related profit margins, product specialization, and cost control. The tables earlier in this report provide a guide of industry best practices outlining how profitable wineries operate.

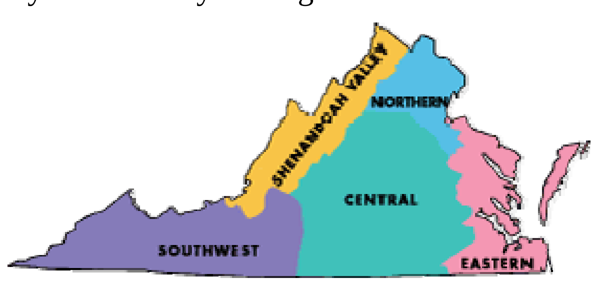
Finally, winery owners need to understand and work toward business models which are achievable. For example, if you plan to produce and sell a relatively low cost wine, you either need to remain fairly small and sell virtually all of your inventory direct to consumer or get large enough to where you benefit from administrative economies of scale. If you plan to produce a higher-end wine, there is a little more flexibility on size, but as the size grows, it is difficult to sell all of it direct to consumer so a portion of sales must be made through lower margin distributors.

METHODOLOGY

The following methodology was employed in conducting this study.

- Project objectives and plans were presented by MKF Research representatives to a meeting of the Virginia Wineries Association the week of November 6, 2006.
- This meeting was followed by interviews the same week, at their locations, a representative sample of 18 Virginia wineries of varying sizes from each of the five major wine regions in the state (see map below), reviewing their business operations and requesting specific financial data from each, with a commitment to confidentiality of enterprise information. Multiple follow up telephone interviews were conducted in the subsequent weeks.
  - The list of financial data requested is presented below.
  - In addition, winery representatives were asked a variety of in-depth, open-ended questions about the nature of their businesses, including:
    - Do you grow or purchase grapes? What varietals? What are your production and purchasing costs?
    - What wines do you produce and why? What is your current production volume and how do you see that changing in the future?
    - How and where do you sell your wine and on what terms? How do you market your wine? What other sources of revenue do you have?
    - What role did self-distribution play in your business and how will the change in the system impact your business, in specific terms?
    - What are the critical issues your business faces? What aspects of your business are unique?
- Winery interviews were supplemented with interviews with additional appropriate individuals involved in the Virginia wine industry including vineyard owners and managers, state government and university personnel, suppliers and service providers and members of Virginia vineyard and winery organizations.
- Data collected during the interview process was systematically analyzed.
  - Key financial ratios were calculated and compared;
  - Qualitative and quantitative drivers of profitability and viability of each of the wineries were identified; and
  - Common factors correlating with winery profitability and viability (or lack thereof) were identified together with relevant groupings of wineries.

From these data and analysis, assessments were made and conclusions developed as the overall profitability and viability of Virginia wineries as described in this report.



Virginia Major Wine Regions

Virginia Winery Profitability Study
Winery Interview
Information Request

12/31/05 or most recent annual financial statements, including:
- Balance Sheet
- Income Statement
- Trial Balance

Projections for 2006 and beyond

Sales information:
- 2005 and 2006 Case and $ Sales
  - by major product (how long does it take to sell through a vintage of each wine)
  - by sales channel (wholesale, retail, tasting room, wine club)
    - Do you use a broker or marketing company to manage wholesalers?
    - What in-state wholesalers do you use?
    - Can you estimate % of wholesale business on-premise vs. off-premise?
    - What % is sold in VA?
    - Do you self-distribute to retailers?
    - Do you sell to ABC stores?
- Non-wine sales (merchandise, etc.)
- Grape sales
- Bulk wine sales

Inventory information:
- 12/31/05 inventory on hand by product
- Cost per case of each product
- Current retail price list

Production costs:
- Grape costs (per varietal)
  - Purchased grapes - cost per ton
  - Grown grapes - farming costs per acre/ton
- Winemaking costs (including overhead allocations)
- Bottling costs (including labor)

Expenses:
- Payroll costs and headcount by department (retail, vineyard, production, sales, admin)
- Selling vs. administrative (identifying major sub-accounts)
- Tasting room
- Wine club
- Events
- What types of marketing do you employ?
- How are you affected by the association and tourist board's promotional efforts?

Assets:
- Fixed Asset detail
  - Vineyard
  - Winery

Financing:
- Debt vs. equity
- Annual debt service

ABOUT MKF RESEARCH

MKF Research LLC is the leading research source on the US wine industry. We continue to strive to raise the bar on the quality of information and analysis available to the wine industry.

MKF Research LLC conducts original research on the business of wine and wine market trends, publishes a number of industry studies and provides business advisory services and custom business research for individual companies and investors. MKF Research LLC also conducts a number of industry seminars on its research work including the annual invitation-only MKF Research Executive Wine Summit as well as various smaller open workshops on key industry issues.

MKF RESEARCH LLC CUSTOM PROJECTS

The major part of MKF Research LLC's business is providing confidential custom consulting to wine industry enterprises, investors and suppliers. Recently, MKF Research LLC consulting projects have included:

- Feasibility, market studies and due diligence;
- Consumer and trade surveys and focus groups;
- Market analyses, marketing strategy development and market, brand and financial and operational benchmarking;
- Economic impact studies for a variety of wine and vineyard related businesses and public and private organizations in the industry; and
- Market and strategic studies of potential new import and export products.

MKF Research LLC conducts the leading research on Winery Direct Sales and Winery Direct consumers and the benchmarking of winery direct activities and has expanded its consumer and trade research capabilities to among the best in the industry.

In 2005 MKF Research LLC was the principal consultant on the Wine Institute's first consumer research in twenty years, a large scale survey of wine consumers conducted by Yankelovich Inc., whom MKF Research LLC introduced to the wine industry. The report produced by MKF Research LLC, ***Wine Institute Market Research: Implications for California Wineries***, is available to members of the Wine Institute.

Visit our website at www.mkfresearch.com to stay informed of our new research projects.