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## Russian River Valley Pinot Noir Vineyards Command High AVA Premium

In this Winery Report we expand our analysis of the value of American Viticultural Areas (AVAs) to the Russian River Valley (RRV) AVA. Again, we use our innovative method - wine price differentials - as the basis for our conclusions. Our analysis revealed a RRV AVA value for prime Pinot Noir vineyards of \$71,600 per acre. This value is not surprising given the strong growth in Pinot Noir grape prices in Sonoma for the past 20 years. Consistent with our prior analysis of other AVAs, we also select a "best value" RRV Pinot.

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### The Importance of the AVA Value

As we have discussed in previous newsletters, the contribution of the appellation to a vineyard's value became much more important in 2010 when the IRS issued a Chief Counsel Memorandum (CCM) concluding that the right to use an appellation or American Viticultural Area designation is an intangible asset, and is amortizable to offset income over a period of 15 years under § 197 of the Internal Revenue Code. Simply put, every dollar of AVA value shields a dollar of vineyard income from tax over 15 years. With purchases of vineyards routinely in the millions and tens of millions of dollars, the value of the AVA has become a material issue for buyers.

### Our Method

As discussed in our 2012 newsletter on the same topic, we believe, along with most wine industry consultants, that grape prices are closely tied to wine prices. Analysis shows that changes in wine prices explain, in statistical terms, about 94% of the change in grape prices. We also postulated in 2012 that if an AVA value exists, it must reveal itself in the prices consumers are willing to pay for wine with the AVA on the label. If consumers aren't willing to pay more for the AVA's wine, then it seems unlikely the AVA grapes could sell for more given the very strong relationship between wine and grape prices. Finally, we needed a method to adjust out of the wine price, the quality difference between the AVA's wines and those from lesser-known appellations. Otherwise, we would be unsure if the higher wine price was due to having the AVA on the label, or due to the higher quality of the wine. We are fortunate in that drinking wine is a favorite pastime for a lot of us and there are a host of services that provide wine ratings for thousands of wines across the country.

Comparing the prices of wines of the *same critic rating* allows us to adjust for quality differences. Making this adjustment is very important as the IRS in the CCM was concerned about methodologies that did not eliminate value attributable to the quality of the property, and by extension the grapes and wine, itself.



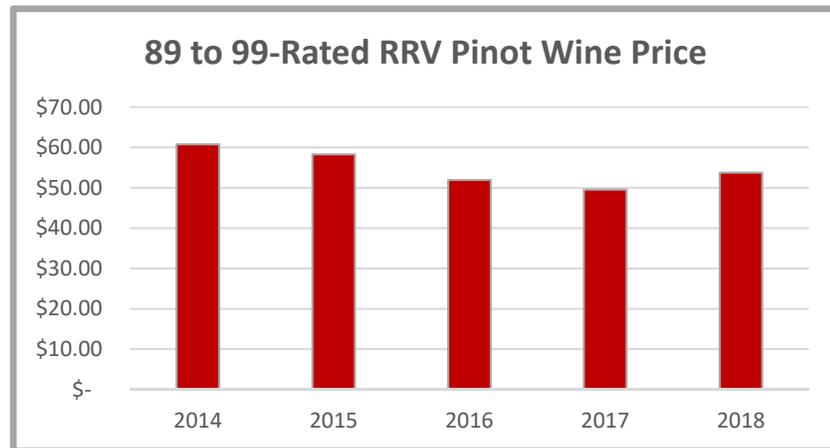
### The Wine Market

Our experience providing AVA valuations over the past few years has revealed that the market for wine is quite efficient, i.e., wine prices react to over and under-supply conditions. This can be seen in the chart below for RRV Pinots with a rating between 89-90 points (the average critic rating of the wines we analyzed between 2014 and 2018).

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*Wine prices react to over and under-supply conditions.*

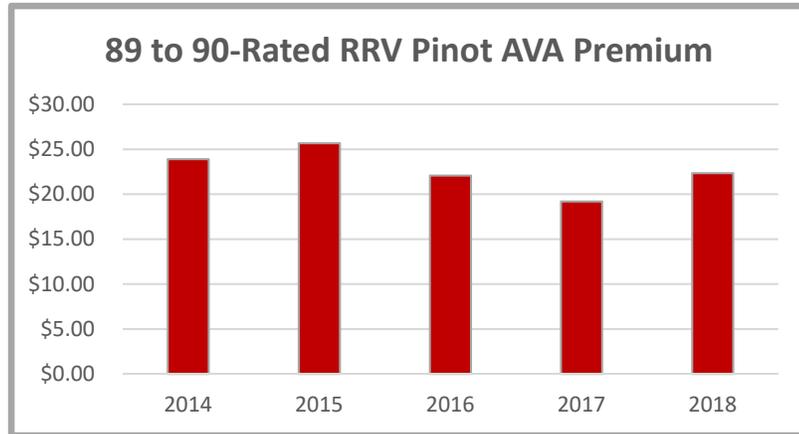
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The 2012 through 2014 vintages, which were sold mostly in 2014 through 2017, were high-yield years in Sonoma. The average yields for Pinot in those years was 4.0 tons per acre, versus a seven-year average of 3.2 tons per acre. It is clear in the chart that the price of very good Pinot decreased due to the over-supply from 2014 through 2017. The over-supply market even impacted 2017 when wineries began selling their 2015 vintage, a very low yielding year. In 2018, Pinot prices recovered a little as crop yields in 2016 (beginning to be sold in 2018) were average, creating a more balanced market. In addition, the loss of some wineries and vineyards in the wine country fires in late 2017 may have impacted the market in 2018.

This is relevant to our AVA valuation method because fluctuations in wine prices can make certain years less meaningful for observation. Using a single year of data that represents an over or under-supply environment will tend to under or over-state the wine price premium attributable to the AVA. And the same market forces that impact the RRV Pinot wine market also impact the lesser-known AVA market. Care must be taken in selecting the period over which to observe the wine market and AVA price premium.

The second graph on the following page shows the RRV Pinot per bottle retail price premium calculated from 2014 to 2018. As expected, the premium also reacts to over and under-supply forces. Selection of the wines that make up the sample of RRV and lesser-known AVA Pinots is very important. It goes without saying that the sample needs to be randomly selected. But beyond that, it is important to select wines that have a number of sellers and that are reviewed by several wine critics. We have found wine prices are much more highly correlated with average critic reviews than the review of a single critic.



#### RRV “Best Value” Pinot

As part of our analysis of the RRV Pinot AVA premium we calculate what a wine *should* sell for based upon its critic rating. Some wines sell for more than the forecast price, and some wines sell for less. This can happen when a vintage is rated significantly higher or lower than the previous same-label vintages, and the winery continues to sell the wine for a comparable price. The RRV Pinot rated as a best value in 2018 was the 2014 Longboard Vineyards Pinot (rated 91).



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