

## The Russian River Valley and Sonoma Coast are the Highest-Value AVAs for Sonoma Chardonnay

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***Our analysis revealed a Sonoma AVA value for prime Chardonnay vineyards of \$42,000 per acre.***

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In this Winery Report we expand our analysis of the value of American Viticultural Areas (AVAs) to the AVAs of Sonoma County. Again, we use our innovative method - wine price differentials - as the basis for our conclusions. Our analysis revealed a Sonoma AVA value for prime Chardonnay vineyards of \$42,000 per acre. We also found the "Russian River Valley" and "Sonoma Coast" appellations had a value slightly above the average, and that the more general "Sonoma County" AVA had a value materially below the average. Consistent with our prior analysis of other AVAs, we also select a couple of "best value" Sonoma Chards.

### 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, 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 closed 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.

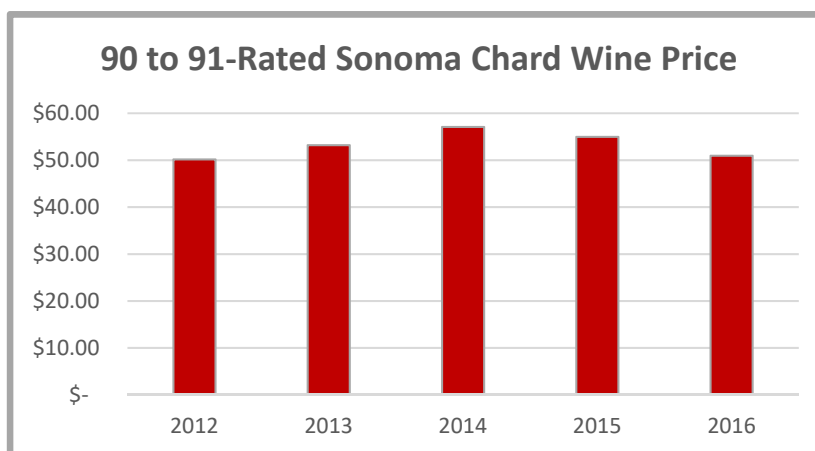
#### The Wine Market

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 Sonoma Chards with a rating between 90-91 points (the average critic rating of the wines we analyzed between 2012 and 2016).

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

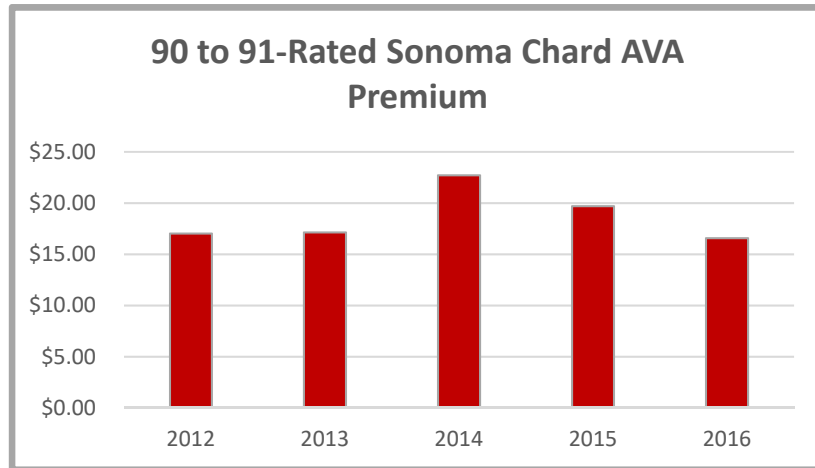
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The 2011 vintage, which was sold mostly in 2014, was a low-yield year in District 3- Sonoma. The average yield for Chardonnay fell to 3.54 tons per acre. It is clear in the chart that the price of very good Chardonnay increased due to the supply shortage in 2014. In 2016, the prices dropped quite significantly, as crop yields in 2013 (sold in 2016) were well above average, creating greater supply.

This is relevant to our AVA valuation method because fluctuations in wine prices can make certain years less meaningful for observation. Using annual 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 Sonoma Chard 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 Sonoma Chard per bottle retail price premium calculated from 2012 to 2016. As expected, the premium also reacts to over and under-supply forces. Selection of the wines that make up the sample of Sonoma and lesser-known AVA Chards 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.



**Sub-AVAs**

A closer examination of the Sonoma sub-AVAs revealed that the “Russian River Valley” was the premium AVA for Sonoma Chardonnay with the “Sonoma Coast” AVA following close behind. The “Sonoma County” appellation showed some value, but was significantly below the average value of \$42,000 per acre. Beyond these data inputs there are many other factors that influence the value of the Sonoma AVA. The suitability of the ground to grow Chardonnay grapes versus other wine grapes is perhaps the most important. In addition, all the factors that affect the value of a vineyard, can impact the value of the AVA - vine condition and age, productivity, operating costs, and grape contracts, for example.



**Sonoma “Best Value” Chards**

As part of our analysis of the Sonoma Chard 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 Sonoma Chards rated as best values in 2016 were the 2013 Gary Farrell Russian River Selection Chardonnay (rated 90) and the 2013 Dehlinger Estate Bottled Unfiltered Chardonnay (rated 91).



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