BarberAnalytics

The Winery Report

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Appellation Valuation and Amortization

How much would you be willing to pay for a bottle of 92-rated Cabernet Sauvignon from Columbia Valley? What about the same bottle from the heart of the Napa Valley in Oakville? It turns out that wine buyers will pay significantly more for the same wine as long as it's from the Napa Valley or some other well-known and highly-regarded appellation. A wine's appellation is a major pricing factor in the consumer's mind. This "appellation premium" has translated into increasing values of vineyard properties in premium appellations. We believe this retail appellation premium can be reliably measured and is perhaps the best way to support the value that the appellation contributes to the value of a purchased vineyard.

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 (AVA) designation, was an intangible asset, and was amortizable to offset income over a period of 15 years under § 197 of the Internal Revenue Code. With prime vineyard values in Napa ranging from $225,000 to $300,000 an acre (with some properties selling well above that range), AVA valuation has become a material financial issue for vineyard buyers.

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Unfortunately, valuing an appellation designation isn't easy as they can't be sold separately from the vineyard. Some practitioners have viewed AVAs as similar to brand names, and valued them using a relief from royalty method. We have some difficulty with this method as it requires determining a royalty rate for the appellation designation, and appellations aren't legally allowed to be licensed for a royalty - so no true comparable transactions exist. Another approach is to compare the vineyard sale price per acre to similar sales in less-well-known appellations, with the AVA designation value being the difference in sale prices. We believe this is sound theory, but it may be difficult to find a suitable AVA comparable to the Napa Valley, for example, in terms of geography, geology and climate. The IRS expressed the same reservations in the CCM and also said that any premium must be due to the AVA designation only, and should not include any value attributable to the quality of the property itself. In essence, the comparable property in our example should be the next undiscovered Napa Valley, which is not easy to find. Another similar method is to examine the price difference paid for grapes from the subject property to a similar property from a lessor-known appellation. Again, this method suffers from the same difficulties as the comparable land sales method.

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Our preferred method, and the one we will examine more closely herein, determines the price differential paid for wine at the retail level. In our analysis, we compare a group of wines similar to the subject vineyard's end product, to similar wines from lessor-known appellations. Once the retail premium for the appellation designation is determined, we reduce it by retailer, distributor, and winery markups. This approach has appeal for a number of reasons. First, it measures the impact of the AVA designation exactly where it matters the most, in the consumer's mind. If you believe an AVA designation has value, it should and must be demonstrated at the consumer level through premium pricing. Second, and perhaps more importantly for the valuation expert, because there is so much information available on wine electronically, it is possible to collect information on a broad sample of similar wines and to adjust for vineyard quality through wine ratings. This addresses the primary concern of the IRS that comparisons be made to comparable quality properties. Since the quality of a property is determined by the quality of the wine it produces, we think it is reasonable to connect the quality of the wine, to the quality of the property.

Valuation of the appellation designation using retail appellation premiums can lead to significant tax savings and should not be over-looked

To demonstrate this method we selected a hypothetical Cabernet Sauvignon vineyard located in the Napa Valley that sold for $250,000 per acre. Wine produced from the vineyard had an average rating of 92. We selected 52 Napa Cabs currently on the market with ratings ranging from 87 to 95. We then ran a regression analysis so that, for a given rating, we could predict a wine price. We like this approach because it helps predict wine prices at the outer boundaries of the ratings. This group had a predicted price of $62.74 for a 92-rated Napa Valley Cab. For the lessor-known-appellation Cabs we selected wines with a "California" designation, those from other states, and some from other New World wine markets. In general, we believe these appellations have little value in the minds of consumers. These wines had ratings between 89 and 95 and had a predicted price of $30.20 for a 92-rated Cab - a price premium of $32.54 for the Napa Valley Cabs. Of course the whole appellation premium isn't paid to the vineyard owner. Retailers, distributors and the winery all take a portion. Using some broad industry assumptions regarding markups and distribution channels, we estimated about $18.26 of the appellation premium would make it back to the winery.

The question now becomes, how much of the appellation premium that makes it to the winery will pass through to the vineyard owner? The vineyard owners and wineries have previously had this discussion regarding the price for wine grapes. We don't think the appellation premium should be viewed any differently as the benefits of the appellation are encompassed in the wine grapes. Certainly there is a range of agreements which result in differing levels of profitability for wine grape growers and wineries. However, there is an old agreement in the Napa Valley wine business called the Bottle Price Formula. It was first negotiated in 1976 between the Napa Valley Grape Growers Association and the major wineries in the Napa Valley, including Mondavi and Christian Brothers. The Bottle Price Formula says that if the retail price of a bottle of wine is $10, then the price per ton of grapes used to make it is $1,000 or 100x the bottle price. Making the same assumptions as above regarding markups and distribution channels, and assuming 700 bottles of wine produced per ton of grapes, this means the grapes make up about 25% of the winery's price of a bottle of wine. Or put another way, the winery would keep 75% of the appellation premium, passing down only 25%, or $4.56 per bottle to the vineyard owner.

Assuming a 4 ton per acre yield and 700 bottles per ton of wine grapes, this translates into additional pretax profit of $12,780 per acre, or $7,579 after California and Federal corporate taxes. Using a capitalization rate of 5.50%, this implies a value for the AVA designation of approximately $138,000 per acre. However, because the AVA designation is now an amortizable asset, it also shields income from tax, which is a benefit in addition to the extra cash flow. This tax amortization benefit increases the value of the AVA designation another $42,000 to $180,000. Our discussions with purchasers of vineyards suggest this result (about 72% of the $250,000 vineyard purchase price) is much higher than amounts which have traditionally been allocated to the appellation designation. Valuation of the appellation designation using retail appellation premiums can lead to significant tax savings and should not be over-looked.

Although we have tried to make our analysis realistic, care should be taken before drawing any broad conclusions. Researchers have found the "appellation effect" on wine prices to be especially high for certain appellations and varietals. The Napa Valley appellation, for example, seems to have a larger impact on the price of Cabernet Sauvignon than it does on Merlot. Also, the San Luis Obispo – Santa Barbara AVAs seems to have a larger impact on the price of Pinot Noir than on Chardonnay.

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