

Direct to Consumer Sales in Small Wineries: A Case Study of Tasting Room and Wine Club Sales

by

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Abstract

Small wineries, in this study defined as those wineries production less than 2,000 cases annually, have relied on direct-to-consumer through tasting room and wine club sales because the small wineries have higher production costs and cannot afford the large discounts required by distributors and other wholesalers. Small wineries have Recent advances in customer relations software has made managing wine clubs more manageable for small wineries. This study uses a case study of a small winery in the Sierra Foothills region of California to examine and compare the cost and profit margin of tasting room and wine club sales. Findings indicate that while tasting rooms have larger costs, the discounted prices offered to wine club members makes the profit margins similar. The study concludes that wine clubs are cheaper and easier for owners of small wineries to manage, but the tasting room is still critical to maintaining the image of the winery.

Introduction

Most large wineries have multiple distribution channels through distributors, brokers, and other wholesalers. The economy of scale of large wineries allows them to give 50-60 percent discount to wholesalers and still maintain a reasonable profit margin. On the other hand, small wineries (here defined as wineries with production less than 2,000 cases annually) have higher production costs than large wineries, and have to rely mostly or solely on direct-to-consumer sales or local distribution to restaurants and stores where profit margins are higher.

Direct-to-consumer sales have traditionally been done through the winery tasting room, but recent relaxation of wine shipping laws in the United States and ease of access to customers through the internet has expanded the opportunities of direct-to-consumer sales for small wineries. Direct-to-consumer sales include tasting rooms, internet, wine club, and internet sales (Teaff *et al*, 2005).

Internet sales take two basic forms. First, potential customers who are not familiar with a particular winery and are surfing the web to find wines that are a good value, or wine brands they are familiar with and like. Second, are previous customers who have visited a particular winery and are interested in buying those wines, but can't come to the winery to make the purchase. It is the second type of buyer that is of interest to the small winery. The buyer looking for a good buy or a name brand can always find one online or at COSTCO or Trader Joes. The competitive advantage of the small winery is that they have a story to sell along with their wine. A customer who buys a COSTCO or Trader Joes wine can place it on the table for his or her guests and tell them about the wine and what a good buy it was, but there is no story about the wine. The small winery has a story that goes along with the wine. The host can tell the guests about how quaint the tasting room was, how the winemaker explained how the wine was made, etc

Recent advances in technology have permitted businesses to capture information on their customers' preferences and increase communication with customers. Customer relations management represents a shift in thinking for everyone in the organization to concentrate on satisfying customers (Ables, 2004), (Franson, 2006a). Wine clubs express this customer relations

philosophy. There are two basic forms of wine clubs. Programs whose members receive periodic, pre-arranged wine orders, and preferred-customer programs whose members don't want periodic shipments but, because they buy large quantities of wine and want to have a close relationship with the winery, receive special discounts. Either of these programs can have various tiers whereby customers can order various numbers of bottles of wine or have wine delivered on various frequencies, or specify which wines they would like to purchase (Tiaf, *et al*,2005).

Managing a wine club requires almost daily interaction with customers as they call or email changes in address, credit cards, etc. The wine club manager is also responsible for maintaining outstanding customer relations through events, sales for club members, emails and other notification of events in the local area, etc.

Purpose

Most small wineries have wine clubs which vary in importance from a minor adjunct to the tasting room sales to a major distribution channel. Some small wineries focus almost exclusively on their wine club (Fannon, 2006b). Despite all the recent interest and expansion of wine clubs, little has been done to examine the profitability of wine clubs sales compared to traditional tasting room sales, or to determine the optimum balance between tasting room and wine club sales. Should the tasting room be the focus of sales, or should it just be used as a recruiting vehicle for wine club sales?

This paper will compare tasting room sales to wine club sales, addressing the following research questions: 1. What is the cost of sales and profit margin for wine club sales compared to tasting room sales? 2. Is there an optimum balance between tasting room and wine club sales?

Methods

The methodology used in this paper is a case study of a small (1,500 cases / year) winery in the Sierra Foothills region of California. The winery was started in 1989, and the tasting room has been in operation since 2000. The wine club was started in 2001.

Research on small businesses is difficult because sales and expense information is proprietary, and small businesses are reluctant to release any information that will benefit competitors. Nonetheless, in this case the owner was willing to disclose actual expenses data for 2007. The owner considered that cost estimates of production, general operating expenses, and cost of sales could be made by anybody based on their personal knowledge of the local wine industry and therefore did not have to remain proprietary. Sales information used in the study will remain proprietary, and estimates of sales used in the study are hypothetical and not based on actual sales. Even though hypothetical sales data is used, the analysis is still useful since readers can interpret the results of the study and adapt them to their own business.

I emphasize that only the comparative cost of wine production, tasting room costs, and costs associated with the wine club are considered in this study. The cost of sales for the winery tasting room and wine club for 2007 will be analyzed and compared, but many very important costs were not considered because they were not relevant to addressing the research question. Cost of developing the winery, cost of land and equipment, debt service, and cost of developing the

tasting room are among the many costs not considered in this study. The numerous federal, state, and county sales, and excise taxes were also not considered because they would be proportional to the sales for both tasting room and wine club sales.

Variables

The variables defined in this study such as Cost of Sales, Cost of Production, Cost of Goods Sold, Sales, and Gross Margin. are defined for purposes of this study and are not necessarily the same terms that would be defined in generally accepted accounting principles. The above variables are defined for this study as follows:

- Cost of Sales = Annual 2007 cost of tasting room and wine club expenses adjusted for hypothetical sales of 1,000, 1,500, and 2,000 case sales.
- Cost of Production = The average expense associated with producing one case of wine
- Cost of Goods Sold = Cost of Sales + Cost of Production
- Sales = Average sale price of one case of wine in 2007
- Gross Margin = Sales – Cost of Goods Sold

Finally, since the profit margins reported in this study reflect only the comparative costs of tasting room and wine club expenses and sales and ignore many other major capital expenses, they do not represent the actual profit that would be expected of a small winery. Nonetheless, the comparison between tasting room and wine club expenses and sales should provide very useful information to winery owners and managers.

Cost of wine production

The cost to produce wine varies widely depending on whether the winery produces wine from its own vineyards or purchases grapes from local growers. Also labor costs and cost of grapes purchased vary from year to year. Considering only the cost of grapes, chemicals and yeast, labor, energy, bottling and other packaging to make wine, production cost for a small winery in the Sierra Foothills region varies between \$25 - \$65 per case. For purposes of this study I will use a production cost of \$45 per case.

Estimates of tasting room sales and expenses

Sale prices of wine sold vary depending on the season, the popularity of the varieties of wine, and the volume discounts. A reasonable estimate of average retail cost of a bottle can be made by averaging the cost of all varieties available for sale. In this case the average retail sale is \$23.00 per bottle or \$276 per case. Costs in this study will be per case at the full retail price. It is understood that this price is slightly inflated because it does not consider volume discounts.

Expenses in this study are actual tasting room expenditures in 2007 for the case study winery's tasting room. The tasting room is open seven days a week and is staffed with one part-time sales person during the week and two sales persons on weekends and holidays. The following expenses were considered for the cost of tasting room sales.

- Cost of wines poured
- The following factors were considered in calculating cost of sales in the tasting room:
 - Cost of wines poured
 - Tasting room staff salaries
 - Utilities
 - Food and glasses
 - Rent

The winery's policy, like the majority of its competitors in the local area, is not to charge for wine tasting. Therefore no cost is recovered by tasting fees for the wine poured for potential customers. The cost of wines poured was calculated as the average retail price of \$267 per case, not the average cost of production price of \$45. The rationale for this decision is small wineries can expect to sell all wines at retail price. Therefore wines poured for promotional purposes are wines that could have been sold at retail prices. This is not true for large wineries that can expense wines poured in tasting rooms at wholesale prices or cost them to marketing expenses and expense them at the cost-of-production price.

Estimates of wine club expenses and sales

Wine club members differ widely in the amount of wine they purchase annually. In this case study wine club members may select the amount of wine they would like to receive quarterly. In amounts of 2, 4, 6 or 12 bottles each quarter. Members can either have the wine shipped to them and pay for packing and shipping, or pick the wine up at the winery and save these shipping costs. While most members select 2-bottle shipment, and a small but significant number select more. A sample of 153 wine club shipments in 2007 indicated an average of 2.76 bottles per shipment. For this study this figure will be rounded off to 3 bottles per shipment. Wine club members receive a 15 percent discount on wine, so wine sold through the wine club was calculated as \$235 per case (retail price of \$276 - 15%). Since wine club members receive an average of three bottles four times a year, members receive an average of one case per year.

The wine club manager is critical to both selling wine club memberships in the tasting room and providing customer service to members. Wine club management seems to hit a threshold at about 300 members. Wine clubs sales fewer than 300 members are considered an adjunct to the tasting room sales and can be managed by a part-time independent contractor. Managing a club with members over that limit requires a full-time employee and payment of workers compensation insurance and other benefits.

The study also assumed that wine club management software is needed. Although the software purchase is a fixed expense, there are also variable expenses associated with maintenance, technical support, and software updates. All of these factors were aggregated and listed as an annual expense with the cost of purchase amortized over a 10 year period. Printing and administrative expenses for wine clubs consists of sending emails and flyers to members advertising events and sales as well as phone calls and internet expenses to manage changes to credit cards, addresses, etc.

Findings

Tasting room

The cost of sales for tasting room is illustrated in Table 1 below. Tasting room costs are based on hypothetical annual sales of 1,000, 1,500, and 2,000 cases sold at an average cost of \$276 per case, with 15 percent of the wine used to pour for customer tasting.

As wine sales increase some of the cost of sales such a salaries and wine poured for tasting increase, while others such as rent and utilities remain the same. In this study I assumed that increasing tasting room sales from 1,000 cases per year to 1,500 cases would require one extra sales person on weekends for an additional salary of \$3,000 and would increase tax and insurance \$500. Increasing sales from 1,500 to 2,000 cases annual sales would increase salary another \$3,000 and insurance another \$500.

Table 1. 2007 Tasting room annual sales costs

Costs	1,000 Cases/Yr.	1,500 Cases/ Yr.	2,000 Cases / Yr.
Wines poured for tasting	\$41,400	\$62,100	\$82,800
Salaries	\$21,000	\$24,000	\$27,000
Utilities	\$700	\$700	\$700
Insurance	\$4,500	\$5,000	\$5,500
Food	\$5,000	\$5,500	\$6,000
Rent	\$8,300	\$8,300	\$8,300
Total	\$80,900	\$105,600	\$130,300

As Table 1 illustrates, the major expense of tasting room sales is the cost of wine poured for tasting, comprising over 50 percent of tasting room expenses. Employee salaries are a distant second expense, comprising about 26 percent of the total costs of tasting room sales.

The data on tasting room sales are confounded somewhat because tasting room sales cannot be completely separated from wine club sales. Customers come in the tasting room, taste the wine, and decide to join the wine club. Also, wine club members can buy wine in the tasting room at discounts. The discounts, cost of the wine poured for wine club members, and other tasting room costs are not charged to the wine club, therefore deflating the calculation of wine club expenses.

Table 2 shows the sales and production costs, retail price, and gross margin for hypothetical sales of 1,000, 1,500, and 2,000. The data assume a cost of production of \$45 per case, a retail sale price of \$276 per case.

Table 2. Tasting room sales and gross margin

Cases	Cost of Sales	Cost of Production	Cost of Goods Sold	Sales @\$276/case	Gross Margin
1,000	\$80,900	\$45,000	\$125,900	\$276,000	\$150,100
1,500	\$105,100	\$67,500	\$172,600	\$414,000	\$241,400
2,000	\$130,300	\$90,000	\$230,300	\$552,000	\$331,700

As can be seen for table 2, cost of sales is considerably higher than cost of production and, while cost of production increases linearly, cost of production tends to flatten a bit as sales increase. Gross margins also tend to follow a linear progression.

Wine club

The largest cost associated with wine clubs is the manager. As can be seen in table 3, this cost increases dramatically as the wine club becomes too large for a part-time contract and requires a full-time employee manager. The relative cost of the manager's salary levels off as the size of the wine club grows.

Table 3. Annual cost of wine club sales

Wine Club Costs	<300 Members	1,000 Members	2000 Members
Manager contract	\$13,000	\$0	\$0
Salaries	\$0	\$30,000	\$40,000
Insurance	\$0	\$4,000	\$5,000
CRM software & hardware	\$300	\$400	\$600
Printing and admin.	\$600	\$2,000	\$3,000
Total	\$13,900	\$36,400	\$48,600

Table 4 illustrates the sales costs and margin for various levels of wine club sales.

Sales were calculated as follows: The average number of bottles sold was 3 bottles per wine club member per shipment. There were 4 annual shipments, so each member received 12 bottles or 1 case of wine per year at a 15 percent discount or \$235 per case.

Table 4. Annual cost of wine club sales and gross margin

Wine Club Members	Cost of Sales	Cost of Production	Cost of Goods Sold	Sales at 15% Discount	Gross Margin
300	\$13,900	\$13,500	\$27,400	\$70,500	\$43,100
1,000	\$36,400	\$45,000	\$81,400	\$235,000	\$153,600
2,000	\$48,600	\$90,000	\$138,600	\$470,000	\$331,400

Although the cost of sales for the wine club is much lower than the cost of tasting room sales, discounting the win for wine club members takes up the margin. Surprisingly, in the end, the gross margin for wine club sales almost exactly matches the tasting room gross sales. The 15 percent discount used in the study somewhat underestimates the actual value of the discount because some members receive larger discounts for volume orders.

Conclusions

The purpose of this study was to compare tasting room sales to wine club sales, addressing the following research questions: 1. What is the cost of sales and profit margin for wine club sales compared to tasting room sales? 2. Is there an optimum balance between tasting room and wine club sales?

With regard to question one, the major expense of tasting room sales is the cost of the wine poured for customer tasting, but this expense is offset by higher retail sales. The cost of sales in tasting rooms, \$80,900 for 1,000 cases, is far lower than the \$34,800 cost of sales for a 1,000

case sale wine club; however, this lower cost of sales in the wine club is offset by the discount given to wine club members, and the gross margin for the two distribution channels is remarkably similar.

A logical strategy to reduce the cost of tasting room sales is to charge customers for wine tasting. This strategy has been used in the major wine regions in California such as Napa Valley and the Central Coast, but has been less frequently used in other California regions. Only two of the twelve wineries in the region of this case study charge for tasting, but the issue is strongly debated. On one hand charging for tasting eliminates the freeloaders who see wine tasting as a cheap way to bar hop. On the other hand, free wine tasting is a courtesy and appeals to visitors' morality (or guilt) to reciprocate the courtesy by buying wine. Pouring wine free also promotes the winery and educates visitors to the various styles of wine. If visitors have a positive experience tasting free wine, they may return later to buy. Unfortunately it is difficult to measure this phenomenon. We know from informal surveys that, when asked, visitors state they object to paying for wine tasting, but further research would be useful to developing predictive models for the appropriate conditions, times, and amounts for wineries to charge for tasting.

The optimum balance between tasting room and wine club sales is also difficult to determine. The profit margins for both are remarkably similar, but the cost of developing a tasting room is much higher than developing a wine club. Further, the day-to-day management a tasting room is far more expensive in terms of both expense and owners' time than a wine club, whose management can be turned over to one employee.

While it is tempting to focus on building the wine club and turning over the management to an employee, there cannot be a wine club without a tasting room. The tasting room is the engine that drives the wine club and is the main recruiting place for wine club members (Franson, 2006b). The tasting room establishes the culture of the winery and tells the story of the wine. Without the tasting room and the wine's story, the wine sold from a wine club would be just another wine competing with all of the other low-cost retailers. A well-managed and upscale tasting room increases the perceived value of the wine and is a place that wine club members can come to be a part of the wine culture and be made to feel like the important customers they are.

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